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# **Economic Summit Countries: The Interest Rate Issue**



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**An Intelligence Memorandum**

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May 1982

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## **Economic Summit Countries: The Interest Rate Issue**

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### **An Intelligence Memorandum**

*Information available as of 7 May 1982  
has been used in the preparation of this report.*

This memorandum was prepared by [redacted] 25X1  
the Office of Global Issues. Comments and queries  
are welcome and may be directed to the Chief,

Economic Analysis Branch, OGI, [redacted] 25X1

This memorandum has been coordinated with the  
National Intelligence Council, [redacted] 25X1

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[REDACTED]  
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**Economic Summit Countries:**

**The Interest Rate Issue** [REDACTED]

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**Summary**

Continuing high US interest rates will almost certainly be a contentious issue at the Versailles Economic Summit. Foreign leaders are pointing to high US rates and budget deficits as causes of high interest rates and economic stagnation in their countries. Although the effect of US rates is being overplayed, US rates have contributed somewhat to high interest charges in some of the Summit countries. The primary impact has been to induce tighter monetary policies in response to capital outflows attracted by the higher US rates.

We believe that interest charges in the Summit countries should decline during 1982. Internal economic conditions abroad, especially the slow-downs in inflation, should bring rates down, and any decline in US interest rates would speed the process.

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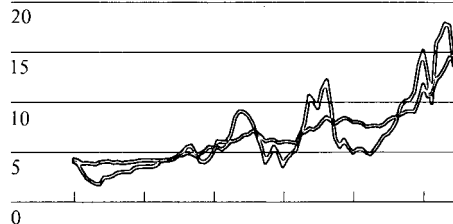
**Figure 1**  
**Summit Countries: Trends in Short- and Long-Term**  
**Interest Rates**

Percent, End of Quarter Quotes

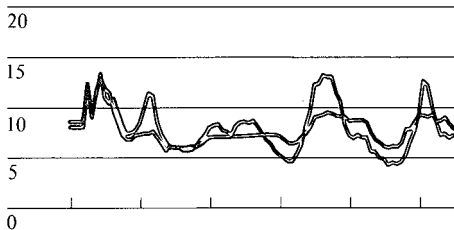
Legend

- Short-term (call money)
- Long-term (government bond yields)

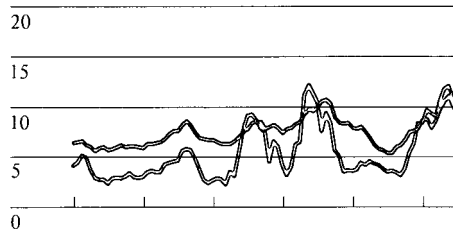
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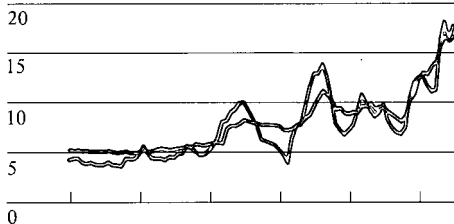
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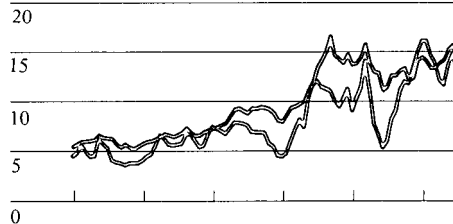
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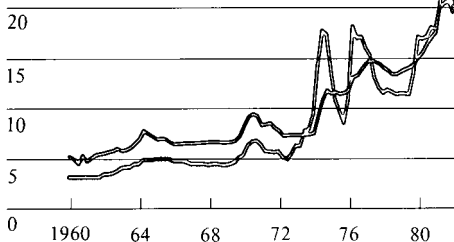
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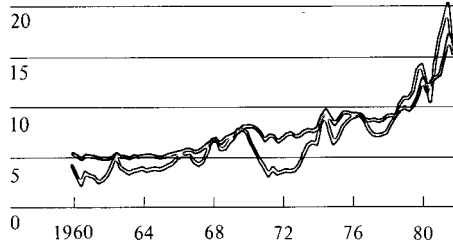
United Kingdom



Italy



Canada



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**Economic Summit Countries:**

**The Interest Rate Issue** [Redacted]

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**Interest Rate Trends**

During 1981, interest rates rose sharply in each of the Summit countries except Japan, where rates fell, and Britain, where they were already high (figure 1). By second-half 1981 both long- and short-term rates had hit record highs in the five other Summit countries:

- West Germany's long- and short-term rates both topped 11 percent in third-quarter 1981, matching the previous peaks of 1973 (short term) and 1974 (long term).
- The 17-percent rates on both long- and short-term money experienced in France in third-quarter 1981 exceeded the previous highs by 4 percentage points.
- In Italy, rates exceeded 20 percent for the first time.
- Rates in Canadian money markets, closely linked to US rates, soared above 20 percent for short-term credit and above 17 percent for long-term commitments during third-quarter 1981. [Redacted]

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In 1982, these rates have softened. By the end of the first quarter, West German short-term interest charges were down substantially and long-term rates down slightly; both short- and long-term rates had declined substantially in the United Kingdom and Canada. In France and Italy, the declines were much smaller. In Japan, where interest rates are relatively low, there has been essentially no movement. Nevertheless, interest charges remain quite high by historical standards in all of the Summit countries except Japan, and real rates are close to record levels. [Redacted]

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**Domestic Factors**

Some foreign leaders and commentators, notably in Canada and Western Europe, have attributed their high interest charges to the high US rates and budget deficits. Trends in their own economies, however, also played important roles (tables 1 and 2). [Redacted]

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***Rates of Inflation***

The pace of inflation appears to have been the key determinant of Summit country nominal interest rates. In countries where inflation was substantially higher in 1981 than in low-interest-rate years—France, Italy, and Canada—nominal long-term interest rates were among the highest. Nominal interest rates were lower in Japan and West Germany, countries with lower inflation. In the United Kingdom and Italy, interest rates remained high despite a substantial drop in inflation last year. A legacy of high inflation in those two countries may account in part for the stickiness of interest rates. [Redacted]

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**Table 1**

**Summit Countries: Qualitative Assessments of Pressures on Interest Rates <sup>a</sup>**

	Inflation	Real Growth	Government Budget Deficit	Monetary Policy	US Rates
United States	Upward	Downward	Same	Upward	
Japan	Downward	Downward	Same	Same	Upward
West Germany	Same	Downward	Same	Upward	Upward
France	Upward	Downward	Upward	Downward	Upward
United Kingdom	Same	Downward	Upward	Same	Upward
Italy	Upward	Downward	Upward	Upward	Upward
Canada	Upward	Downward	Upward	Same	Upward

<sup>a</sup> Qualitative assessments of pressures on interest rates were made by comparing trends in the various determinants of interest rates in 1981 with the trends in 1980 and in years in which interest rates were low. As a rule, if 1981 inflation, real growth, government budget deficits, and US interest rates were higher, these determinants were judged to be putting upward pressure on rates; if changes in monetary stocks were less in 1981, this factor was also judged to be providing upward pressure. The data used in this analysis are presented in table 2.

[Redacted]

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***Budget Deficits***

Rising budget deficits also seem to have contributed to the upsurge in interest rates last year. In each of the countries except West Germany and Japan, deficits as a proportion of GNP were substantially higher than in periods of low interest rates; in France and Italy, moreover, the deficits increased sharply. The prospect of further increases in deficits may have placed additional upward pressure on interest rates. [Redacted]

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***Real Credit Demands***

Sluggish real economic activity probably exerted downward pressure on interest rates during the last year in all of the countries. [Redacted]

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***Monetary Policy***

Monetary policy apparently also boosted interest rates in West Germany and Italy. In these countries, stocks of central bank money and the broadly defined money stock (M2) grew significantly slower than in the years of low interest rates. Moreover, monetary growth in these two countries was slower in 1981 than in 1980. These slowdowns restricted increases in credit availability and, while lowering inflation, kept nominal rates high and increased real interest rates. In Japan, interest rates fell last year as money stock growth picked up from the very low pace of 1980. [Redacted]

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Table 2

Percent

## Summit Countries: Comparison of Trends in Interest Rates and Selected Determinants

	Low Interest Years <sup>a</sup>	1980	1981	Low Interest Years <sup>a</sup>	1980	1981
<b>United States</b>				<b>France (continued)</b>		
Short-term interest rates <sup>b</sup>	5.4	15.9	13.6	Domestic-US long-term interest rate differential <sup>§</sup>	1.0	1.4
Long-term interest rates <sup>b</sup>	7.0	12.2	14.1	Change in exchange rate with dollar <sup>h</sup>	5.5	-6.3
Inflation <sup>c</sup>	5.4	9.8	8.9		-21.8	
Real economic growth <sup>d</sup>	4.0	-0.3	0.9	<b>United Kingdom</b>		
Government budget deficit <sup>e</sup>	2.6	2.6	2.5	Short-term interest rates <sup>b</sup>	5.9	13.8
Change in money stock (M2) <sup>f</sup>	9.6	7.6	6.1	Long-term interest rates <sup>b</sup>	9.6	13.3
<b>Japan</b>				Inflation <sup>c</sup>	9.2	17.0
Short-term interest rates <sup>b</sup>	4.8	10.0	6.9	Real economic growth <sup>d</sup>	2.8	-1.9
Long-term interest rates <sup>b</sup>	6.6	9.3	8.3	Government budget deficit <sup>e</sup>	1.1	4.7
Inflation <sup>c</sup>	4.7	4.3	2.3	Change in money stock (M2) <sup>f</sup>	15.0	18.5
Real economic growth <sup>d</sup>	6.8	3.8	1.8	Domestic-US short-term interest rate differential <sup>§</sup>	0.4	-2.1
Government budget deficit <sup>e</sup>	3.6	4.7	4.2	Domestic-US long-term interest rate differential <sup>§</sup>	3.0	1.1
Change in money stock (M2) <sup>f</sup>	18.2	6.8	10.7	Change in exchange rate with dollar <sup>h</sup>	NEGL	10.5
Domestic-US short-term interest rate differential <sup>§</sup>	-1.7	-5.8	-6.7		-21.1	
Domestic-US long-term interest rate differential <sup>§</sup>	-0.5	-2.9	-5.8	<b>Italy</b>		
Change in exchange rate with dollar <sup>h</sup>	16.8	13.3	-6.2	Short-term interest rates <sup>b</sup>	6.8	17.9
<b>West Germany</b>				Long-term interest rates <sup>b</sup>	8.8	17.1
Short-term interest rates <sup>b</sup>	4.4	9.0	10.9	Inflation <sup>c</sup>	9.4	19.8
Long-term interest rates <sup>b</sup>	7.3	8.6	10.0	Real economic growth <sup>d</sup>	4.4	0.5
Inflation <sup>c</sup>	4.6	5.1	4.6	Government budget deficit <sup>e</sup>	8.3	10.8
Real economic growth <sup>d</sup>	3.3	-0.6	0.4	Change in money stock (M2) <sup>f</sup>	19.5	12.2
Government budget deficit <sup>e</sup>	1.7	1.9	2.6	Domestic-US short-term interest rate differential <sup>§</sup>	0.7	2.0
Change in money stock (M2) <sup>f</sup>	11.1	4.5	3.7	Domestic-US long-term interest rate differential <sup>§</sup>	1.9	4.9
Domestic-US short-term interest rate differential <sup>§</sup>	-1.6	-6.9	-2.7	Change in exchange rate with dollar <sup>h</sup>	0.8	-9.4
Domestic-US long-term interest rate differential <sup>§</sup>	0.0	-3.6	-4.1		-24.3	
Change in exchange rate with dollar <sup>h</sup>	7.6	-7.6	-14.9	<b>Canada</b>		
<b>France</b>				Short-term interest rates <sup>b</sup>	5.5	14.2
Short-term interest rates <sup>b</sup>	6.7	10.9	16.1	Long-term interest rates <sup>b</sup>	7.8	13.0
Long-term interest rates <sup>b</sup>	8.0	13.6	16.2	Inflation <sup>c</sup>	7.8	9.8
Inflation <sup>c</sup>	8.1	10.9	13.3	Real economic growth <sup>d</sup>	4.6	0.5
Real economic growth <sup>d</sup>	5.0	0.2	1.5	Government budget deficit <sup>e</sup>	0.9	4.3
Government budget deficit <sup>e</sup>	0.6	NEGL	2.8	Change in money stock (M2) <sup>f</sup>	14.5	9.5
Change in money stock (M2) <sup>f</sup>	16.3	8.3	15.6	Domestic-US short-term interest rate differential <sup>§</sup>	-1.4	-1.6
Domestic-US short-term interest rate differential <sup>§</sup>	0.5	-4.9	2.5	Domestic-US long-term interest rate differential <sup>§</sup>	0.8	0.7
				Change in exchange rate with dollar <sup>h</sup>	-0.1	-0.8
					-0.7	

<sup>a</sup> Low interest years are those years in 1970-79 in which the yearend interest rates were below the average for the decade.

<sup>b</sup> Yearend quotes.

<sup>c</sup> Percent change in GNP deflator, fourth quarter to fourth quarter.

<sup>d</sup> Percent change in real GNP, fourth quarter to fourth quarter.

<sup>e</sup> Calendar year deficit as a percent of GNP.

<sup>f</sup> Percent change in M2 definition of money supply, fourth quarter to fourth quarter.

<sup>§</sup> Yearend domestic quotes minus yearend US quotes, for the years corresponding to the domestic country's low interest years, percentage points.

<sup>h</sup> Percent change fourth quarter to fourth quarter.

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**The Role of US Rates**

Aside from the well-established influence of US interest rates on Canadian financial markets, internal economic conditions and policy decisions in the other Summit countries generally determine their domestic interest rates. During the last year, however, US interest rate trends have also been influential. A number of Summit countries have responded to high US rates by tightening monetary policies to limit capital outflows and currency depreciations. As a result, their interest rates are higher:

- In West Germany, higher US interest rates reinforced the upward movement in West German interest charges by creating an unusually large West German-US interest rate differential. This differential stimulated an outflow of capital from West Germany that the Bundesbank responded to by tightening monetary policy.
- High US interest rates have also induced policy responses from the Japanese. Specifically, to limit outflows to US money markets, Tokyo has tightened controls on international capital flows. This response contributed to the decline in nominal interest rates already under way because of weak economic growth and slowing inflation, but has not been sufficient to prevent high real rates.
- In the United Kingdom, the impact of US interest rates is not as clear-cut as in Japan and West Germany, but there are indications that US rates have helped hold UK interest charges up. In particular, UK rates did not decline in 1981 despite slowing inflation, essentially no economic growth, a declining budget deficit, and continued increases in the money supply. [redacted]

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US rates chiefly affected French and Italian rates indirectly, through forces created within the European Monetary System by the higher West German rates. This effect has been overshadowed, however, by substantial upward pressure on interest rates from domestic factors. The size of government budget deficits in both countries jumped substantially—in France from approximate balance to nearly 3 percent of GNP—and stood well above levels prevailing in low-interest-rate years. In France interest rates were likely also boosted by a sharp acceleration in inflation, and in Italy by particularly severe tightening of monetary policy. [redacted]

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**Outlook and  
Implications**

Interest rates in the Summit countries should decline slowly during the remainder of 1982. Several factors will contribute to this outcome:

- Any decline in US rates will put some downward pressure on interest charges abroad.
- Real rates are extremely high, as inflation has dropped but nominal interest rates have not (figure 2). If the slowdowns in inflation that have occurred in West Germany, Japan, the United Kingdom, and Italy continue, expectations of high inflation should gradually diminish and, in turn, lead to a drop in nominal interest rates. 25X1
- It seems probable that monetary policy in some countries will be loosened in response to weak real economic conditions and high unemployment. [redacted]

Forces that might inhibit lower interest rates in 1982 include a revival in real economic activity, which would increase private demand for credit, and continued or faster-than-expected rises in government demands for credit. These forces could keep interest rates at or near present high levels. In turn, the expected recoveries, which are based in part on anticipation of falling interest charges, would have much slower going, and pressures would build for loosening monetary or fiscal policy in all of the Summit countries. [redacted] 25X1

If Summit governments respond by adopting more expansionary fiscal stances, with no change in monetary policy, then a probable outcome will be more favorable growth prospects, little change in inflation, but a continuation of high interest rates. Should the monetary option be chosen, growth prospects would improve, both nominal and real interest rates would likely decline, but the seeds would be sown for accelerated inflation in 1983. Given the already high level of budget deficits and the relatively tight monetary stances in several Summit countries, we expect most expansionary shifts to occur in monetary policy. [redacted] 25X1

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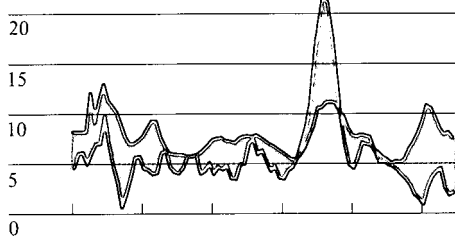
**Figure 2**  
**Summit Countries: Interest Rates and Inflation**

Percent

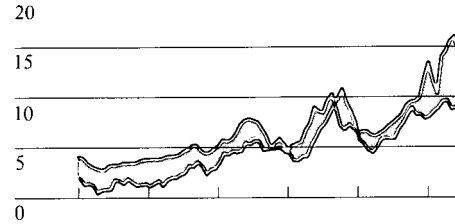
Legend

- Fourth-quarter changes in GNP deflator (percent)
- Average of short- and long-term interest rates (percent)
- Periods of positive real interest rates
- Periods of negative real interest rates

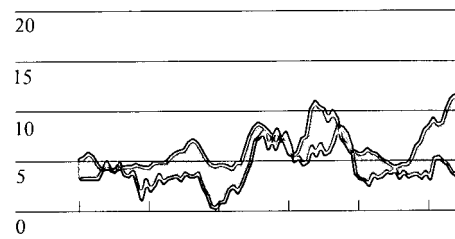
Japan



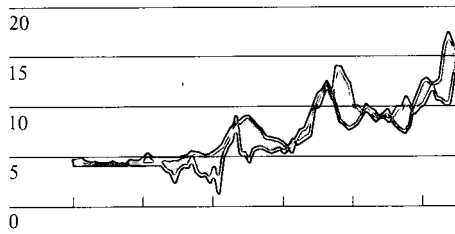
United States



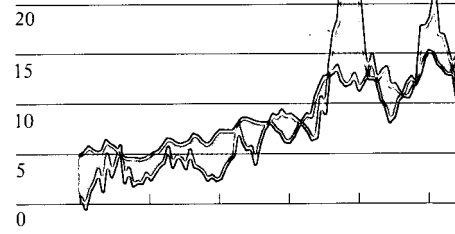
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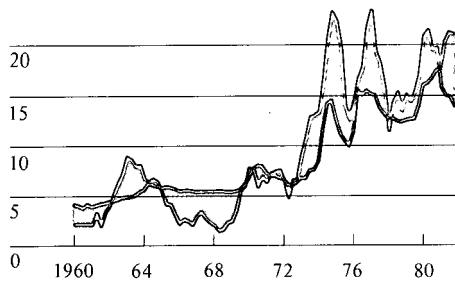
France



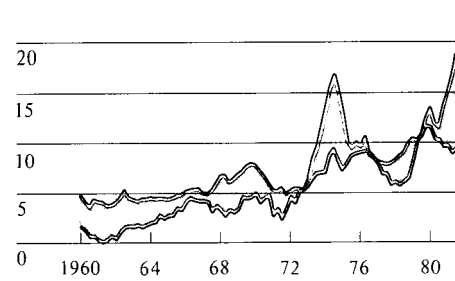
United Kingdom



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