TRANSMITTAL SLIP | DATE 5/5/87

TO: Deane Hoffman

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REMARKS:

FROM:

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Venice Summit 15 May 87

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Central Intelligence Agency

Washington, D.C. 20505

15 May 1987

MEMORANDUM FOR: Stephen P. Farrar
Director, International Economic Affairs
National Security Council

FROM: [redacted] 25X1
Chief, West Europe Division
Office of European Analysis

SUBJECT: Presidential Briefing on Economic Policy Coordination Among Summit Countries

1. Attached please find the briefing you requested from Deane Hoffman on the current account imbalances facing the Summit countries. It is based on a typescript, also attached, done at the request of several US policymakers involved in preparations for the Venice Summit.

2. We hope you find the material useful in preparing for the 21 May briefing of the President. [redacted] 25X1 25X1 25X1
As part of the pre-Summit work, we prepared a collection of 24 papers dealing with a range of Summit issues, including the typescript on policy coordination noted above. Steve Danzansky and Fritz Ermarth have copies of the book at the NSC.

3. We have appreciated the opportunity to help you and if we can be of further assistance please call me [redacted] 25X1 25X1

[redacted]

Attachments:
As stated.

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[redacted]

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Briefing Paper on the Current Account Imbalances of the Summit Countries

We see ominous clouds on the world economic horizon. The huge existing current account imbalances of the major countries, in our view, are not sustainable, but the dollar's extraordinary decline to date is not enough by itself to solve the problem. The US-Japan imbalance is by far the major problem, though the West German surplus is not insignificant.

What is required, according to our analysis, is a coordinated approach that combines a substantial increase in fiscal stimulus in Japan and West Germany, planned reductions in the US fiscal deficit, and further exchange rate adjustments. Without such an approach, the risks are high of the non-US OECD countries slipping into recession.

[redacted] 25X1 we believe that a significant shift to fiscal stimulation is very unlikely, and further, that there is a danger Tokyo may not follow through completely with its proposed one-year stimulus package. The willingness of both countries to take appropriate measures depends on a host of domestic political contraints and their own assessments of the severity of the problems. Even a strong US demarche focused on the downside risks would probably not work unless they perceive a real threat to domestic economic growth.

-- While we doubt that Prime Minister Nakasone has much room to maneuver at this time beyond the announced $34 billion stimulation package, the danger is that this package may contain a fair amount of window dressing. A strong US demarche might help persuade the Prime Minister to work hard to maximize the package's stimulative impact.

-- West German Finance Minister Stoltenberg is a strong advocate of fiscal austerity. Although Economics Minister Bangemann indicated at the recent OECD ministerial that Bonn would reconsider its economic policy if growth remained slack, Stoltenberg afterward stressed that West Germany already has done all it can to promote growth. In any case, we believe stimulative measures, if taken, would likely be modest.

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Despite the dollar's extraordinary decline,* our analysis, as well as studies by the OECD, [redacted] [redacted] and others, indicate that this is not enough by itself to significantly reduce the huge current account imbalances of the US, Japan, and West Germany. If we assume no further changes in exchange rates, the US budget deficit, or foreign government policies (beyond the fiscal packages that Tokyo and Bonn are preparing for 1987 and 1988, respectively), and if OECD economic growth is steady at 2.5-3.0 percent annually, we find that (see Table 1): 25X1 25X1

-- The US current account deficit would merely level off for two years and then resume its rapid rise because of rising debt service costs, while the Japanese surplus would remain huge and the West German surplus would decline moderately.

-- Latin America -- which includes most of the troubled LDC debtors -- would do well, registering solid GDP growth and declining current account deficits because exports would increase -- their currencies have moved with the US dollar.

This projection, however, appears untenable because the world will not continue indefinitely to absorb huge amounts of US debt -- at least not at current interest rates. Hence, we would expect further significant dollar depreciation as a result of the continuing runup of US foreign deficits.

An additional significant depreciation of the dollar -- on the order of 30 percent -- accompanied by success in reducing the US budget deficit, in line with targets in Gramm-Rudman, would result in a major improvement in the US current account but cause serious economic difficulties for Europe, Japan and the less developed countries (see Table 2).

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*Since February 1985 we calculate that it has plunged 32 percent against the other OECD currencies on a real, trade-weighted basis -- the sharpest decline ever recorded by a summit country currency in a 26-month period (see figure).

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-- The US current account deficit would fall to a manageable $25 billion after four years. But the Japanese and West German surpluses measured in dollar terms would remain large, essentially putting the burden of adjustment on other OECD countries.

-- The other Summit countries should find this policy scenario particularly worrisome since this sharp improvement in US price-competitiveness would lead to zero economic growth in the rest of the OECD for two years.

-- The Latin American economies would be hurt badly by rising import prices and falling exports.

Our analysis indicates that the least painful way for the world economy to get out of the current imbalance is through a difficult-to-achieve combination of US fiscal restraint, foreign fiscal expansion, and less drastic exchange rate changes (see Table 3). The US suffers, however, in that economic growth falls to 1.5 percent annually in 1989-90:

-- Specifically we assume that:

  o the US budget deficit falls to zero over four years as prescribed by Gramm-Rudman;

  o to offset this the Japanese deficit increases to nearly 5 percent of GDP and the West German deficit rises close to 3 percent of GDP;

  o the yen and mark appreciate an additional 20 percent and 10 percent, respectively, in real terms.

-- In this case the US current account deficit would be cut in half over four years, while the West German surplus would disappear and the Japanese surplus would decline by three-fourths -- all without inflicting recession on any country.

-- Latin America would do very well. Its current account would move into substantial surplus while economic growth would average slightly over 4 percent annually.

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This scenario is not falling into place, however, because of Japanese and West German unwillingness to provide the needed fiscal stimulus. In order to try to persuade Tokyo and Bonn of the need for action, it may be useful to stress that the likely outcome in the absence of any action -- further dollar depreciation and cuts in the US fiscal deficit -- would be much worse than in a policy scenario based on coordinated action and much more expansionary Japanese and West German fiscal policy.

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TABLE 1

Summit Countries: Baseline Projections of Current Accounts and Real GNP Growth*

	United States	Japan	West Germany	Other Summit	Other OECD	Latin America
Current Account (billions US $)						
1987	-144	71	43	-9	-5	-9
1988	-143	67	32	-20	-14	-8
1989	-156	73	24	-29	-7	-1
1990	-180	86	25	-33	-3	1
Real GNP Growth (percent)						
1987	3.0	3.0	1.5	2.6	2.1	4.1
1988	3.0	3.5	2.0	2.4	2.5	4.1
1989	2.5	3.8	2.8	2.5	2.5	4.1
1990	2.5	3.8	2.8	2.5	2.5	3.9

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*These baseline projections are not forecasts. They assume that the real exchange rates and foreign government policies in place or planned in late April are unchanged. The US deficit as a share of GNP remains unchanged over the projected period.

TABLE 2

Summit Countries: Effects of 30 Percent Real Dollar Depreciation Combined with US Gramm-Rudman Fiscal Targets

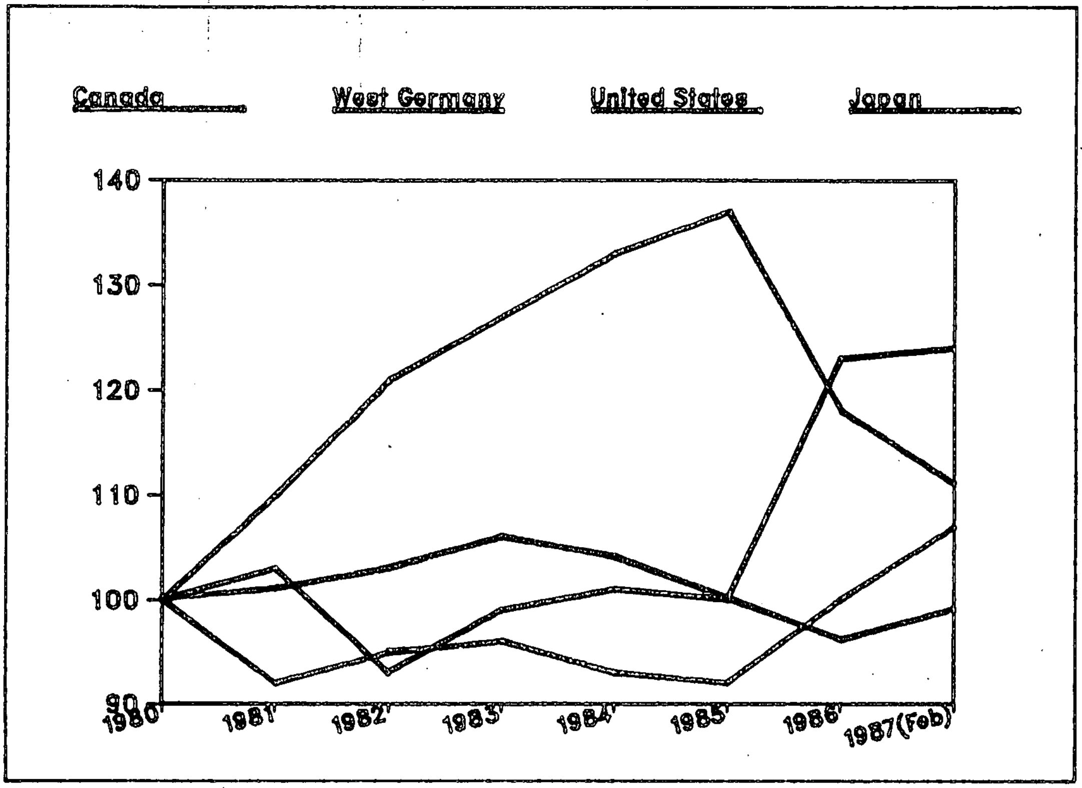
	United States		Japan		West Germany		Other Summit		Other OECD		Latin America	
	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline
Current Accoount (billions US $)												
1987	-142	2	77	6	60	17	-5	-4	-1	4	-18	-9
1988	-84	59	63	-4	56	24	-41	-21	-30	-16	-17	-11
1989	-44	112	65	-8	46	22	-76	-47	-45	-38	-6	-5
1990	-25	155	77	-9	45	20	-96	-63	-57	-54	1	0
Real GNP Growth (percent)												
1987	3.0	0	-1.0	-4.0	0	-1.5	.4	-2.2	.1	-2.0	3.8	-.3
1988	3.0	0	.5	-4.0	.4	-1.6	.4	-2.0	-.4	-2.9	4.1	0
1989	2.5	0	2.3	-1.5	1.9	-.9	1.5	-1.0	.4	-2.1	4.3	.2
1990	2.5	0	2.9	-.9	2.3	-.5	2.2	-.3	1.5	-1.0	4.0	.1

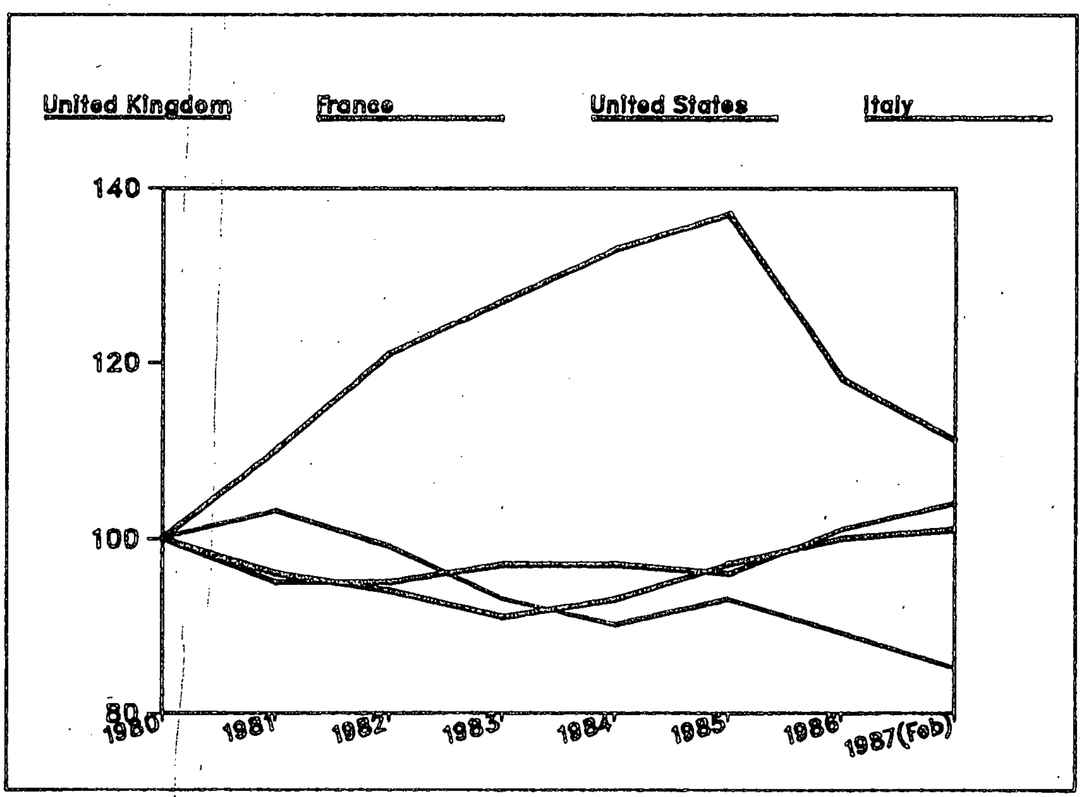
TABLE 3

Summit Countries: Combination of 10 Percent Real Mark Appreciation, 20 Percent Real Yen Appreciation, Big Six Fiscal Stimulation, and US Fiscal Restraint (Gramm-Rudman)

	United States		Japan		West Germany		Other Summit		Other OECD		Latin America	
	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline	Level	Change from Baseline
Current Account (billions US $)												
1987	-129	15	64	-7	44	3	-11	-2	-6	-1	-8	1
1988	-100	43	32	-35	23	-11	-20	0	-5	8	-4	4
1989	-84	72	20	-53	8	-16	-30	0	5	12	7	8
1990	-72	108	20	-66	3	-21	-39	-6	9	12	13	12
Real GNP Growth (percent)												
1987	2.0	-1.0	3.0	0	1.5	0	2.6	0	2.1	0	4.3	.2
1988	2.0	-1.0	3.5	0	2.0	0	2.4	0	2.5	0	4.3	.2
1989	1.5	-1.0	3.8	0	2.8	0	2.5	0	2.5	0	4.1	0
1990	1.5	-1.0	3.8	0	2.8	0	2.5	0	2.5	0	3.8	.1

Summit Countries: Real Trade-Weighted Exchange Rates*
(1980 = 100)





*Source: Based on Morgan Guaranty Trust trade-weighted real exchange rates against 18 industrialized and 22 developing countries.