PO-CH/NL/0063

PART A

Part A.

RESTRICTED.

Begins: 11/4/84
Ends: 18/4/84

PO -CH /NL/0063
PART A

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PART A

Chancellor's (Lawson) Papers:

SIR PETER MIDDLETON'S
VISIT TO WASHINGTON
APRIL 1984

Disposal Directions 25 Years

[signature]
21/7/95

11/4/84.

MEETING WITH MR. STEPHEN AXILROD, STAFF DIRECTOR FOR MONETARY & FINANCIAL POLICY FEDERAL RESERVE BOARD ON APRIL 10 AT 4.30 P.M.

1. Mr. Axilrod said that the first quarter's GNP growth had been much stronger than expected. Growth would probably moderate in the second quarter - there were indications that both retail sales and industrial production in March would be weak. But this was only a pause and he expected steady growth in the second half of the year. There was little sign of any slowdown in business spending, and it was probable that the accelerator effects on investment had overcome the effects of high interest rates. The Federal Reserve's main concern was to curb inflation.

2. Commenting on the recent increase in interest rates, Mr. Axilrod said that the Federal Reserve had followed the market. The 0.5% increase in the Discount Rate was not as dramatic as it might have been since it followed the second increase in the Prime rate. He thought the financial markets were now steady and the exchange markets were quiet too.

3. Sir Peter Middleton asked about the Federal Reserve's views on inflation. Mr. Axilrod said that the outlook was favourable, but higher inflfation could come from a couple of possible sources. Firstly, firms might come under pressure to raise margins, especially as they were also likely to be large net borrowers in the markets in coming months. Firms had been reluctant to pass on cost increases to date, but some might now be forced too. Secondly, a stronger than expected recovery in Europe might add to inflationary pressures. Sir Peter Middleton commented that growth in both West Germany and the UK was likely to be some 3% this year. His main concern was also to see lower inflation in the UK.

4. Turning to monetary policy Mr Axilrod said that all the main monetary aggregates were now moving within their target ranges, although both M1 and M3 were close to the top of their ranges. But the credit aggregate was running above the top of its target range. The Federal Reserve tended to use the credit aggregate as a proxy for the growth of nominal GNP. But the aggregates were now better behaved than this time last year when seasonal factors and the movement of funds into IRA accounts had led to large swings in the weekly M1 numbers.

5. Sir Peter Middleton commented that the monetary aggregates in the UK were also within their target ranges. There had recently been discussion over the adoption of the narrow aggregate Mo in the UK, reflecting the Treasury's desire to monitor the growth of a non-interest bearing aggregate. Mr. Axilrod said that there should be little difficulty in ensuring that Mo remained within the range since it could be controlled, as the aggregate was dominated by currency.

6. Commenting on the setting of monetary targets, Sir Peter Middleton added that in the UK most of the attention was focused on whether the target ranges were met or not. There was relatively little attention paid to the magnitude of the actual range itself.

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7. Sir Peter Middleton said that the main objective of policy in the UK was to gradually lower the rate of growth of the money supply and reduce the PSBR to around 1% of GNP. Mr. Axilrod commented that these were desirable objectives, the problem in the US was of course the large size of the projected budget deficits. Sir Peter Middleton added there must always be a temptation to reduce the size of the debt by monetizing it, since it was essentially a tax which any Government did not need prior legislative approval to impose. Mr. Axilrod said he had great confidence in Mr. Volcker's determination to resist such pressures in view of the inflationary consequences.

8. The meeting ended at 5.05 p.m.

J J M EXETER
11 April, 1984

11/4/84.

RECORD OF MEETING WITH SIR PETER MIDDLETON AND J. KICHLINE - DIRECTOR, RESEARCH AND STATISTICS DIVISION, FEDERAL RESERVE
APRIL 10, 1984 AT 4.05 P.M.

1. Sir Peter Middleton opened the discussion and asked about the Federal Reserve's short term forecast of the US economy. Mr. Kichline replied that he had expected the economy to show more moderate growth in the first quarter, reflecting the steady 5.0% growth in the final quarter of 1983. The first quarter had been surprisingly strong and this had led the FOMC to slightly raise its forecast for economic growth in 1984 at the last FOMC meeting. Growth would moderate in the second quarter, and he then expected the economy to grow steadily at between 3.5 - 4.0% during the second half of the year.

2. Sir Peter Middleton commented that higher growth was likely to be achieved with a higher level of interest rates than many had previously thought possible. The bankers he had met on Wall Street had been pessimistic about the effect of higher interest rates. Mr. Kichline replied that the recent rise in interest rates reflected the strength of the economy, especially the growth of industrial production and the sharp fall in unemployment. He thought it unlikely that interest rates would raise to the levels predicted by some Wall Street analysts. The Federal Reserve's main concern was with inflation. The outlook on inflation was encouraging . Wage increases had been moderate to date. The main risk was perhaps the effect on inflationary expectations of a large settlement in the auto industry, which was due to negotiate a wage increase later in the summer. But it would need a very large price shock indeed to raise the underlying inflation rate to a double digit by the end of the year, as Milton Friedman had recently forecast.

3. Sir Peter Middleton stressed that the UK had no interest in seeing higher inflation in the US. The UK was also concerned over the effect of high US real interest rates, especially as the large capital inflows meant that other countries had to substantially increase their dollar holdings. Mr. Kichline replied that this is also a matter of concern to the Federal Reserve.

4. Sir Peter Middleton commented that one of the main problems was clearly the conduct of monetary policy against the background of a large budget deficit. UK experience in the 1970's had suggested that funding large deficits led to higher interest rates either because of the scale of the borrowing requirement, or just simply market uncertainty over whether large deficits could be financed. In the UK there was a definite link between the conduct of fiscal and monetary policy. The Bank of England had shared the Treasury's objective of lowering the rate of growth of the money supply and the size of the PSBR. It was unusual for a Finance Department such as the US Treasury not to want to cut the deficit more quickly. Mr. Kichline agreed.

5. Sir Peter Middleton asked about the Fed's views on the prospects for the world economy, noting that there was now signs of a steady recovery in domestic demand in several countries of Western Europe.

6. Mr. Kichline replied that the Fed had tended to underestimate the pace of the world recovery, including the recovery in the UK. Sir Peter Middleton referred to the problems in measuring the growth in the UK's GNP at present, which reflected statistical factors and structural changes in the economy. Mr. Kichline added that the Fed's forecast for the major industrial economies in 1985 was for growth at 3% (fourth quarter on fourth quarter), implying slower US growth and some increase in US inflation, the GNP deflator rising at 5.5%. This forecast included only a modest fall in the value of the dollar. But there was some uncertainty over the forecast of the growth of real output since both the US and UK had recently experienced strong productivity growth, but he had doubts as to how strong the underlying growth in producitivity was.

7. The meeting ended at 4.30 p.m.

J J M EXETER
11 April, 1984

11/4/84.

cc: PS/Chancellor
Sir Peter Middleton
Mr. Littler
Mr. Unwin
Mr. Lavelle
Mr. Walsh

RECORD OF MEETING HELD IN CHAIRMAN VOLCKER'S OFFICE
FEDERAL RESERVE BOARD, WASHINGTON DC
ON TUESDAY, APRIL 10, 1984, AT 3.00 PM

Present:

Chairman Paul Volcker
Mr. E.M. Truman, Director, International Finance Division

Sir Peter Middleton
Mr. N.L. Wicks

US Economy

1. Mr. Volcker, in a somewhat sombre mood, said that he would feel more comfortable if significant reductions in the budget deficit could be agreed in the next six months. But he was certain that there would be no agreement before the election.

2. Sir Peter Middleton commented that the large US external deficit was also troubling. Its financing suggested that overseas investors needed to double their dollar portfolio within a relatively short space of time. Mr. Volcker said that the issue was whether adjustment of the internal and external deficits would come the easy or the hard way. Sir Peter Middleton said that while he hoped that adjustment would not be accompanied by higher interest rates, it was clearly important to avoid a large increase in US inflation.

3. Mr. Volcker then said that he had just returned from an economic conference at which he had asked the economists present about the effect on the dollar exchange rate of an immediate $50 billion reduction in the budget deficit. The economists had been evenly split. His own view was that there would be some decline in the dollar, but this would not cause inflationary pressures provided that there was no increase in protectionism. Sir Peter Middleton said that he thought that the dollar would also come down a bit, assuming unchanged monetary policies. But he could not see how the US trade deficit could be reduced while the budget deficit remained high. Mr. Volcker said that he had argued that very point before a congressional committee that very morning.

/World Economy

World Economy

4. Sir Peter said that despite all the progress made, the international debt problem was still worrying. Mr. Volcker commented that higher interest rates were the "curved ball" here. It looked as if the problems of Venezuela and Mexico had been dealt with. Brazil's and Argentina's were still outstanding. But if the first two countries' problems could continue to be contained, difficulties with the other two could probably be absorbed.

5. Mr. Volcker said that the US recovery had particularly helped the Japanese and Canadian economies. It had also given a significant boost to the Europeans, and he showed Sir Peter figures which demonstrated this. Sir Peter said that he too was split-minded on developments in the US economy. It was undoubtedly helping world growth, and he certainly would not want to see a sudden halt.

UK Economy

6. Turning to the UK economy, Sir Peter said that the Government's economic policy would continue on its present lines. There was reason for confidence that inflation would fall to around 4 per cent by the end of the year. Mr. Truman commented that the Fed's forecasts assumed an increase in UK inflation to 5-3/4 per cent, assuming little change in the exchange rate.

Unemployment

7. Mr. Volcker then said that it was paradoxical that political sensitivity about unemployment was greater in the United States than in Europe, even though unemployment was lower in the United States and was still falling. Sir Peter said that unemployment was undoubtedly an issue in Europe, though there was no concerted campaign for reflation. Unemployment was not yet falling despite the significant increases in output, probably because of the large productivity increases in the British economy.

8. Mr. Volcker said that there were already potential capacity problems in some industries in the United States; even sheet steel was in short supply. Sir Peter said that physical shortage of plant was not a problem in the UK. Real wages were increasing too fast, but the productivity increases were moderating the effect on unit costs. Inflationary expectations were not high.

The City of London

9. Referring to developments in the City of London, Mr. Volcker said that he had the feeling that the Bank of England was taking over the whole of the City. Sir Peter replied that the Government was encouraging the Bank to develop its role, though they wanted market forces to determine efficient institutional structures. He believed it particularly important to increase the City's capital base, though he would not want to achieve this by putting the City into the ownership of

the four clearing banks. Mr. Volcker said that he did not support United States' banks involvement in underwriting. But his arguments were undercut by developments in the City of London where banks were increasingly involved in the securities markets. Sir Peter responded that the banks' security business would be kept separate from their banking business. Mr. Volcker appeared sceptical that this could be managed, and pointed out that both British and US banks were not so well endowed with capital as to be able to enter new and risky ventures.

10. The meeting closed at 4 pm.

N.L.W.

N.L. Wicks
Washington DC
April 11, 1984

11/4/84.

cc: PS/Chancellor
Sir Peter Middleton
Mr. Littler
Mr. Unwin
Mr. Lavelle
Mr. Walsh

RECORD OF MEETING HELD IN THE MANAGING DIRECTOR'S OFFICE AT THE INTERNATIONAL MONETARY FUND, WASHINGTON DC, ON TUESDAY, APRIL 10, 1984, AT 9.45.AM

Present:

The Managing Director	Sir Peter Middleton
Mr. Alan Whittome, Director European Department	Mr. N.L. Wicks

World Economy and the US Budget Deficit

1. The Managing Director opened the discussion by praising the Chancellor of the Exchequer's budget. He then went on to say that the paramount problem facing the world economy was rising interest rates. Sir Peter Middleton commented that higher interest rates would cause problems for the UK and other developed countries, but would cause even greater problems for the developing world. The Managing Director said that increases in interest rates, by adding to balance of payments burdens, could push some countries over the edge of social and political tolerance. The higher rates were clearly linked to the US budget. It was perhaps encouraging that there had been recent indications of greater sensitivity in Congress and in the Administration to the problems caused by the budget deficit. But for the present there were no signs that it was going to be dealt with in a fundamental way. It was the major risk for 1984. Sir Peter Middleton said that the increasing interest rates were the inevitable consequence of the large deficit and the tight monetary policy. The large US current account deficit was equally troubling. The richest country in the world should not be sucking in capital at its present rate.

Argentina

3. Sir Peter Middleton then said that he hoped that action to deal with the international debt problems could be kept concentrated in the Fund. He was not much attracted to the sort of action recently taken for Argentina. Sudden moves to counter the assistance of particular countries could weaken the Fund's position. Accounting regulations for the US banks should not drive policy. The Managing Director replied that the Argentine exercise had been intended simply as a bridging operation. He had gone to considerable lengths to avoid too close involvement by the Fund. Some had pressed him to "give a green light". He had refused, and merely stated in a written report, signed with the Argentine authorities, that the Fund and the Argentine Government were pursuing discussions.

/The report was

The report was just a photograph of the position. The episode had, however, been helpful to the Fund Management in pursuing these discussions. The Argentinians had agreed, in a letter, to quantified objectives on the budget deficit, to take a more sensible view of wage policy, and to accept the principle of positive real interest rates and exchange rate flexibility. These were obvious points but they nevertheless represented progress since the Argentine opening position had been so far from the Fund's. Obviously there were still many specific matters on which agreement was necessary for a Fund program. Discussions would no doubt be protracted, especially as Mr. Grunspan seemed to believe that things would happen simply because he uttered the relevant words. He would have another meeting with Mr. Grunspan this afternoon. The pressure would be on the Argentinians to produce proposals for a viable program, though, of course, Fund Management would help them as much as they could. Sir Peter Middleton reminded the Managing Director of the particular UK political sensitivities regarding lending to Argentina and emphasised the importance of the international financial community operating under a Fund umbrella.

4. In reply to a question about the motivation of the four countries who had made loans to Argentina, the Managing Director said that the Mexicans were the driving force. They wanted political leadership. They did not want to see another South American country undermining "the rules of the game" when they, Mexico, had scrupulously abided by them. For all these reasons the Managing Director did not think that the Argentine episode had weakened the Fund's position. It certainly would have been weakened if the Fund Management had been prevailed upon "to give the green light" to a Fund program.

Fund Business

5. In answer to Sir Peter Middleton's question aboud Fund business in the rest of 1984, the Managing Director said that there was no immediate pressure on Fund resources. He had deliberately been very cautious on the size of countries' access in order to conserve Fund money.

6. The Managing Director then drew attention to the forthcoming important debate in the Board on countries' prolonged use of resources. Sir Peter Middleton gave his view that the Fund was primarily an instrument for securing economic adjustment and for correcting misallocation of resources within countries. The Managing Director said that that was exactly his view. The Fund had to be ready to put modest resources on the table if it was to persuade countries to undertake the necessary adjustment. But they could never take on the financing burden for the country concerned. It was important for the Fund to match a country's repurchases with its ability to repay. He was therefore urging the Fund Staff to be cautious in extending new money to regular users. Some countries, particularly France, wanted larger access for the regular users, but he was firmly opposed to such a policy.

/7. The Managing Director

7. The Managing Director then referred to his discussion the previous day with the President of the Dominican Republic about that country's Extended Fund Facility (EFF). The President had wanted access at the 102 per cent level. The Managing Director had told him that his inclination ought to be to cancel the program completely. In the end, they settled on a 67 per cent access limit. (Later in the meeting, a message was brought to the Managing Director to the effect that the President of the Dominican Republic had to see the MD within the hour. The Managing Director commented that no doubt the President's Ministers had pressed the President to return to the charge. But he would not weaken his position.)

8. Sir Peter Middleton commented that the problems of the regular users of Fund resources brought the discussion back to the problems caused for the world economy by the US budget deficit. The Managing Director said that it was the major problem for international economic surveillance. If US inflation was to be kept down, nominal GDP needed to expand at some 8-9 per cent instead of its present 11-12 per cent. This emphasised the prospect of likely higher interest rates. Already Brazil, which was still in the intensive care unit, was arguing that they could not accept the additional burden imposed by higher rates.

The UK Economy

9. Responding to the Managing Director's request to comment on the development of the UK's economy, Mr. Whittome said that while he applauded the adjustment effort already made, he wished that the UK would be braver since there was much more still to do. In particular, the public sector expenditure as a percentage of GDP should be reduced, particularly as oil revenues would be declining in the years ahead. Sir Peter Middleton said that oil revenues would not experience a rapid decline. But he agreed that expenditure control was the key. There was now a much better chance that the Government could keep its expenditure to planned levels. The Treasury had recently introduced a more efficient system for a monthly monitoring of expenditure and revenues. A larger contingency reserve had also been established which would now cover for the increases in demand-led expenditure. Last July's public expenditure measures had established the important principle that Ministers were now responsible for all expenditures within their program, even though some were demand-determined.

10. The meeting adjourned at 10.30 am.

N.L.W

N.L. Wicks
Washington DC
April 11, 1984

12/4/84.

MEETING WITH MR. ALLEN WALLIS, UNDER SECRETARY FOR ECONOMIC AFFAIRS - STATE DEPARTMENT, ON APRIL 11 AT 3.15 P.M.

1. The discussion covered four main issues; unitary taxation, the UK economy, the US economy and prospects for poorer countries.

Unitary Taxation

2. Sir Peter Middleton said he hoped a satisfactory solution could be found. There could be a danger of unitary taxation spreading to other countries. Mr. Wallis said there had been two helpful developments in recent months; the decision by the UK Chamber of Commerce not to visit Florida and the representations made by Japanese investors in California. These had impressed many states as to the seriousness of foreign investors' concern. The main problem was for California which had a conflict between its short run aims of not losing revenue and the longer term issue of not losing investment.

The UK Economy

3. Sir Peter Middleton asked how Mr. Wallis saw the prospects for European economic growth, since there was now a recovery in domestic demand in Europe. Mr. Wallis was more pessimistic and believed there would only be slow growth in Europe.

4. Sir Peter Middleton said that the UK had achieved 3% GNP growth in 1983 and was likely to maintain it through 1984. The policy objective was to secure sustained growth and low inflation. In one sense the basic shift in macro-economic policy had occurred in the mid 1970's, away from stimulating aggregate demand to an emphasis on lowering the rate of growth of the money supply and budget deficits. The policy had been successful since inflation had been steadily reduced. Mr. Wallis commented that the level of unemployment remained a serious problem. Sir Peter Middleton agreed, although in part this was a reflection of strong productivity growth.

5. Mr. Wallis asked whether the welfare state had adversely affected attitudes to work in Britain. Sir Peter Middleton replied that it had not. The main change had been in the present Government's determination to reduce union power and thereby help to create greater flexibility in the labour market. He agreed that the labour market was still rigid, especially in comparison to the US. But many of the important changes introduced by the Government had concentrated on micro-economic policies including the removal of exchange controls, income policies, de-regulating the financial sector and encouraging the sale of council houses.

6. Mr. Wallis asked whether the sale of council houses had been controversial. Sir Peter Middleton said that it was to begin with, but many tenants who now had the option to buy welcomed the change and this had moderated the opposition's criticism. The Government had been able to sell houses at market rates and house prices had tended to rise. Above all the policy was intended to improve labour mobility.

7. Mr. Wallis added that a further feature which could assist mobility was improved pension plans. An important feature of the tax system in the US was the opportunity now provided for individuals to avoid paying tax on money invested in IRA's. Sir Peter Middleton commented that he was interested in this approach, but his own view was that it was in general desirable to avoid building tax relief

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measures into the tax system. In principle he preferred broader based taxes and lower tax rates. He was doubtful whether measures such as the creation of IRA's would significantly raise savings.

The US Economy

8. Turning to the US economy Sir Peter Middleton said he had received rather mixed views on the prospects for the US economy. There was concern over the recent rise in interest rates, but there was also a basic confidence in the strength of the US economy. Mr. Wallis replied that the Administration was less concerned over the recent rise in interest rates than the press. He was also content to see a continuation of large inflows of capital to help finance the deficit. Sir Peter Middleton drew attention to the dangers of relying on the large inflows for the purchase of Treasury securities.

Prospects for LDC's

9. Mr. Wallis was pessimistic about the prospects for many LDC's. The Administration had just announced a $0.5 bn programme to assist poor countries in Africa, but it was uncertain whether these countries could absorb the funds effectively. The problem was bad government and the reluctance to adopt appropriate policies. Unfortunately, the international agencies had little say in these internal matters.

10. Sir Peter Middleton commented that the debt problems could be exacerbated by higher US interest rates, although stronger OECD growth might overcome the effects of higher rates. Mr. Wallis agreed and added that a fall in the dollar would help the debt problem. Sir Peter Middleton said that while in his view the dollar would gradually fall, it was unlikely to fall sharply. The large budget deficit and a resolute anti-inflationary monetary policy would keep interest rates firm, and the dollar reasonably steady.

11. The meeting ended at 4.00 p.m.

J J M EXETER
12 April, 1984

12/4/84

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND MR FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, AT 10.30 A.M. ON 11 APRIL, 1984

Sir Peter Middleton explained that he was on a catching-up visit after the annual UK Budget exercise. Mr Bergsten noted that the UK Budget had been well received.

2. Mr Bergsten said that the US domestic economy had been stimulated into growth by an expansionary fiscal policy. On the external side, it had deteriorated and was continuing to deteriorate. Protectionist sentiment was growing, and he thought that 80% of this was related to the over-valued dollar exchange rate. An IIE study had found that, in the post-war period, the best leading indicator of US protectionist attitudes was the level of the exchange rate. In this light, it was small wonder that protectionism existed at the present time: the over-valuation of the dollar amounted to a 25% tax on exports. There was even a proposal in the Congress for a 30% import surcharge, but the Administration had announced that it would oppose this. He thought that the proposal would not get passed, but that this year the Administration would agree to take action at the micro level (e.g. on shoes, copper and steel) if the dollar stayed at its present level, as seemed likely in the short run. But the present position was clearly unstable: the national debt would double in five years, and the external surplus built up over many years would be demolished in three. In short, while the immediate problem was the growth of protectionism, in the longer run there would be a sharp decline in the dollar at some point, possibly more inflation and probably also an interest rate response.

3. Sir Peter Middleton said that he expected inflation to be reduced somewhat in the UK this year, and pointed out that the UK economy had had 3% growth since the beginning of 1981. It was hoped to sustain this happy situation for at least two or three years, but it was subject to jolts from the outside. If the dollar did fall substantially, it was probable that sterling would be allowed to rise, although interest rates might also be reduced a bit. Any resulting world inflation would be unwelcome in the UK. Mr Bergsten commented that the drop in the dollar exchange rate was likely to be very quick when it came and to over-shoot.

4. On debt, Mr Bergsten said that William Cline of the IIE had been doing some of the most authoritative work on this subject. The initial results - which were broadly that the world debt situation was

/sustainable

sustainable given a reasonable economic scenario - had been criticised in some quarters as being too optimistic. It had been asked whether the present ad hoc approach to debt problems would succeed given higher than expected interest rates. Although interest rates were somewhat higher than expected at the time Cline's original work had been conducted, growth was also somewhat higher. One per cent extra growth in OECD countries was seven times more important to the debtor nations than a one per cent reduction in LIBOR. Also, the present approach was not wholly ad hoc. The rescue operations for each country had common characteristics and proceeded by a set of rules - albeit unwritten ones. This was not to say, of course, that particular debtor countries could not run into trouble. Sir Peter Middleton interjected that a particular difficulty in the present approach was that banking regulations differed in different countries. Those in the United States had been somewhat unhelpful.

5. Mr Bergsten said that it would help the present liquidity situation of the LDCs if the IMF could allocate more SDRs. Otherwise, these countries would have to increase their exports even more aggressively in a protectionist world and compress their imports even more savagely. He thought that a new SDR allocation would be non-inflationary and in any case this could be guaranteed by also imposing reconstitution. Sir Peter Middleton commented that there might be a modest SDR allocation later on in the year - he was against requiring reconstitution

6. Mr Bergsten then began a discussion of the prospects for reform of the world monetary system and commented on the very slow pace of the G10 work programme. Sir Peter Middleton said that an immediate issue for the UK was whether or not to join the EMS exchange rate mechanism. This was becoming a more reasonable proposition as European economies converged. It was pointed out by Mr Bergsten that the present pattern of exchange rates might not be the best one to adopt to start out a system of target zones. But he thought that his main objection to the EMS was that concentration on regional target zones might inhibit the development of such zones on a worldwide basis. He acknowledged however that the EMS had disciplined European economies, especially that of France. Sir Peter Middleton said that, if the UK joined the EMS, it would have to live with German monetary policy - which he thought might not be too onerous for the UK for the present. The present was what was relevant, because the EMS was not intended to preserve exchange rates in any given pattern for all time. Mr Bergsten commented that he thought that recent EMS alignments had been conducted in a sensible way.

/7.

7. Sir Peter Middleton said that EMS membership for the UK was inevitably entwined with other non-monetary EC issues. But it could also stir up interest in the adoption of target zones more generally. Mr Bergsten ended the meeting by saying that he thought that some of the continental countries were not unhappy with the under-valuation of their exchange rates. This was not a healthy phenomenon given the risk of a possible rapid and excessive drop in the dollar exchange rate.

H G Walsh

12 April 1984

British Embassy
Washington

12/4/84.

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND MR JOSEPH WRIGHT, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, AT 9.45 A.M. ON 11 APRIL 1984

Sir Peter Middleton said that, with the UK budget out of the way, he could now bring himself up to date with developments in the US. He had found that tax changes were more difficult to "sell" in the UK than expenditure changes, but the main problem was with entitlements on both sides of the account. The United Kingdom had prepared a Green Paper which projected public expenditure forward over ten years in order to point out the size of the entitlements problem to the public, and the last UK budget had introduced a down-payment on reforms to the British tax system. He had noticed that a climate favourable to tax reform was also present in the United States.

2. Mr Wright commented that it was right to proceed cautiously and piecemeal in achieving deficit reductions; it was undesirable to take on too many special interest groups at once. Reforms in tax and public expenditure programmes could not be rushed and had to be carefully prepared with a public relations campaign. In 1981 in the US, many short-term cost-control measures were introduced, but only in the most favourable political circumstances. He confirmed that the United States would be getting into the tax reform area, although he had been surprised when the President in an election year had detailed the areas which would be under consideration by those studying the reform of the tax system. One of the items under consideration was a VAT, but he thought that several sectors might have to be exempt - perhaps the basics such as food, fuel and housing. It was probably more difficult to achieve tax reform in the United States than in the UK, because marginal tax rates were not so high and consequently the incentive to give up loopholes in order to achieve rate reductions was not as great.

3. Mr Wright said that the evidence from the public opinion polls was that Americans were now more concerned with the budget deficit than they were in achieving reductions in income tax rates. Such concern was not necessarily related to any particular economic theory about how the budget deficit affected interest rates, but this did not make the concern any less. Sir Peter Middleton commented that the UK had had high budget deficits in the past and had had a similar experience - people felt vaguely uncomfortable.

/4.

4. Mr Wright said that he thought the President would be willing to accept the closing of loopholes to raise tax revenues, but not the raising of tax rates. On the expenditure side, there was now an attempt to level off the growth of various programmes, as opposed to trying to disqualify individuals from entitlements or abolishing programmes altogether. In other words, the strategy would be to reduce the amount of spending on each entitlement programme, for instance by reducing indexing provisions. Sir Peter Middleton commented that in the UK there had been a successful attempt to reduce indexing - some UK entitlement programmes had been attached to earnings but this was being changed to prices. Once entitlements were on a price-linked basis, there would be an attempt to reduce the degree of price indexation.

5. Mr Wright commented that US budgeting was really on a one-year basis. This was unfortunate. He wondered whether there was any way of disciplining Cabinet Secretaries for over-spending and asked about the practice on this in the UK. Sir Peter Middleton said that the practice when an over-spend appeared likely was first to ask the Department for offsetting savings in the same programme. There was then an attempt - often futile - to cut other programmes including sometimes those of other departments. In the last resort, a drawing had to be made on the contingency reserve. He thought that, to make the system effective, a realistic contingency reserve was essential.

H G Walsh

12 April 1984

British Embassy
Washington

had been collapsed from 15 to 5 and funds were made available to the pool that way. The US complaints procedure was that, if a person did not get a bonus when he thought he deserved one, then he could appeal to the Supervisor to whom his Supervisor worked. But the actual rating for bonus purposes was a management prerogative, and this had been upheld by the Merit System Protection Board. The introduction of a merit pay system always involved a constant struggle in getting it right; it could not be introduced and then just forgotten about. Asked about the rating system in the UK, Sir Peter Middleton said it involved five levels of marking in annual reports - the minimum to make the marks appear fair and sensible. One main reason why he wanted to introduce a merit pay system was to provide motivation for people who had peaked, but who were doing a good job at their existing level.

4. Sir Peter Middleton said that he was carrying out a campaign to make the pension contributions of all UK public sector employees explicit instead of sometimes having them implicit because of the present system of abating pay. The aim was to have a fairly homogenous and explicit system throughout the public sector. This could cause particular difficulties in the case of the Armed Forces and teachers, whose present non-contributary schemes had inadequate abatement of pay to finance the pensions that these groups received. Dr Devine commented that the US Civil Service pension scheme had a massive unfunded liability of $500 bn and of $1,000 bn if the military were included.

5. Dr Devine asked about the regular meetings of Permanent Secretaries held in Whitehall. Sir Peter Middleton said that there was a regular Wednesday meeting of all Permanent Secretaries chaired by the Cabinet Secretary (or by himself if the Cabinet Secretary was not available). The agenda was entirely open, and no papers were prepared or notes taken. There were also two other meetings of Permanent Secretaries, including one he chaired that included the heads of the main economic departments. The second was one that the Cabinet Secretary chaired - the Senior Appointments Selection Committee - that reviewed appointments in the three highest grades in the UK Civil Service.

H G Walsh

12 April 1984

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Washington

12/4/84.

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND MR JOHN CHAPOTON (ASSISTANT SECRETARY FOR TAX POLICY, AND MR CHARLES McLURE (DEPUTY ASSISTANT SECRETARY FOR TAX POLICY), US TREASURY, AT 11.15 A.M. ON 10 APRIL 1984

Sir Peter Middleton said that the recent UK Budget was devoted largely to sorting out the UK tax system, especially company taxation. The main themes of tax reform in the UK were simplification, cutting out unjustified allowances, and getting a reasonable relationship between marginal rates of tax throughout the income spectrum. A small move was also being made in the direction of basing more tax on expenditure rather than income. He thought that it was possible to wait too long to make the desirable reforms in order to be able to buy out all the losers from any change. But in the UK it had been decided to simplify even in the context of a neutral budget (some groups would therefore be adversely affected). He asked about the study that Secretary Regan had undertaken about the reform of the US tax system.

2. Mr McLure said that Secretary Regan's study was intended to be revenue-neutral. One of the options under consideration was moving to a "flat rate" system on a broader definition of taxable income, so as to reduce marginal tax rates. But he would not go so far in this direction as to disqualify deductions for legitimate interest costs and depreciation. Therefore he thought that a full-blown flat-rate tax was not likely, but it was possible that rates would be made a little flatter. This pattern would not be new. Mr McLure showed Sir Peter a chart which illustrated that - except at the extreme upper end - the US personal tax system had flat marginal rates in 1961. But inflation in the subsequent period to 1969 had made the system progressive across a broader band.

3. Mr McLure said that an expenditure tax was being considered in the US. This had merits in terms of collection, but was perhaps unrealistic. Sir Peter Middleton said that an expenditure tax-based system might be preferred if the tax system were being developed from scratch. But this was unlikely in the real world. It was desirable to move away from the present system of income tax (which had as one characteristic high rates that nobody paid) but one could not go immediately to an expenditure-based system from the present arrangement. The UK reforms had therefore been aimed at sorting out problems with the present income-based system.

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4. In a discussion of Value Added Tax, Sir Peter Middleton said that, when the UK had originally moved to VAT, it had made the mistake of exempting or zero-rating too many categories - including fuel, food, transport and construction. It would have been better to introduce a VAT with a wider base and a lower rate. Mr McLure said that the US was thinking of introducing a VAT or sales tax, but realistically some categories would have to be exempt - perhaps food and medicine. One problem with VAT was the absence of a Federal collection system and the risk that the States would object to the Federal tax system preempting indirect taxation, a major source of revenue for them.

5. Sir Peter Middleton commented that the UK would probably aim at reforming personal taxation in next year's budget. Mr McLure commented that the US should have reduced personal allowances and deductions in its tax system at the same time as the rate reductions that began in 1981.

Unitary Tax

6. Mr McLure said that the final meeting of the Unitary Tax Task Force had now taken place, and the group was in the process of writing up its report in time for the meeting of the full Working Group on 1 May. The Report would not be available before the meeting of the Working Group took place. Sir Peter Middleton said that unitary tax caused political problems in the UK, especially amongst the Government's own supporters. The pressure came in the form of proposals to eliminate Advance Corporation Tax advantages that American investors were given under the UK/US Tax Treaty if they were based in unitary States. This pressure put the UK Government in a difficult position. He thought that in any case unitary tax was a bad lesson for the US to teach the rest of the world, since US multi-national companies had most at risk. Mr McLure commented that, for its part, the US "was not wild" about being under threat of having the ACT benefit withdrawn. On the other hand, the individual States often said to him that the threats of retaliation by foreign governments were without foundation, and threats helped keep up the pressure against unitary tax.

Federal Excise Tax

7. Sir Peter Middleton raised the question of the US Federal Excise Tax on insurance premiums relating to US risks insured abroad, and the withdrawal of the UK exemption from this tax under a

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proposal from the Senate Finance Committee. He said he understood how the proposal arose under the US governmental system, but he would have hoped that, if a loophole existed, the US Treasury would have consulted the UK at an early stage in the tradition of close consultation between the Treasuries or Internal Revenue Service authorities on such matters. (At this point Assistant Secretary Chapoton joined the meeting.) A breach of the DTA was involved.

Indexed Gilts

8. In reply to a question by Mr McLure, Sir Peter Middleton said that indexed gilts had been introduced mainly because this was a good "buy" for the UK Government at a time when interest rates were about 20%, and when the Government had a policy of getting inflation down. The implementation of this scheme had been successful, although it was opposed by the Bank of England when it was introduced for several reasons. These included that the introduction of indexed gilts would prevent the Government from convincing the public that the Government was really determined to get inflation down; that these bonds would be snapped up by foreign buyers (thus driving up the exchange rate); and that they would lead to the spread of indexation to other fields. He believed that the high American deficit would lead the US authorities to diversify the means of its financing. This had been the experience in the UK.

9. Sir Peter Middleton confirmed that, as with normal gilts, the uprating for prices of the principal on indexed gilts was exempt from capital gains tax. Mr Chapoton commented that he thought that this exemption was undesirable. But clearly the general principle of indexed debt was a separate matter from its capital gains treatment. Mr McLure asked why companies did not borrow on the basis of normal fixed debt, charge the interest off against their corporate tax, and then invest in indexed gilts to enjoy a tax-free capital gain. Sir Peter Middleton said that in fact UK companies did not exploit such arbitrage. But he would have to find out why they did not.

H G Walsh

12 April 1984

British Embassy
Washington

13/4/84.

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND MR BOB DAVIS, SENIOR ECONOMIST, JOINT ECONOMIC COMMITTEE, AT 2.45 P.M. ON 12 APRIL 1984

1. Mr Davis said that he had hoped that his Chairman (Senator Jepsen) could have been present for the meeting, but the latter had only just emerged from a long hearing and was behind schedule.

2. Mr Davis said that the US economy was doing rather well, and in particular there had been a rise in the trend of productivity. Trend productivity growth was now about 1½ to 2%, not as impressive as at some periods in the past, but better than in the 1970s. The average marginal rate of income taxation had also been reduced, and was now back at the levels of 1977-79. Federal public expenditure was 25% of GNP, and the tax yield was 19% of GNP, the difference representing the Federal deficit.

3. Mr Davis said that, over a long period, a problem with the US economy was that it was deprived of capital in the later stages of the business cycle. He thought that, if no further progress was made in reducing the budget deficit relative to GNP, the same thing would occur during this cycle and the improvement in productivity established in the past few years would deteriorate. He expected a budget deficit of $150 bn to remain even in 1988, but by then this would represent only 3% of GNP and would be more tolerable. It was the Government's aim to reduce the deficit by means of reductions in expenditure and not by increases in taxation. He doubted whether there were clear advantages to financing expenditure by taxes as opposed to borrowing. There was also the risk that increased taxes could, through the political process, lead to increased spending simply because more revenue was available. The main inflationary effect of a big budget deficit was the fear that it would be monetised; this outweighed any direct effect. Sir Peter Middleton commented that he thought there was some evidence for this: interest rates tended to get pulled up from the long end in the UK, which was where inflationary expectations might be expected to have their main effect.

4. On the immediate growth prospect for 1984, Mr Davis forecast a slow-down in the 7.2% annual rate of growth achieved in the first quarter in the US, and he thought that the actual deficit for FY84 would be $15 bn less than had been forecast. He also thought that the downpayment package for FY85-FY87 would pass, representing a modest gain, and that next year there would be more ambitious plans for the control of public expenditure programmes. An important part

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of keeping public expenditure under control was keeping inflation under control, since this was what drove many entitlement programmes. On the monetary side, he had been pleased with the Fed's performance since last summer, although previous to that he had been unhappy with the excessive gyrations in the money supply. Sir Peter Middleton commented that US monetary policy was important to the UK. It had as big an effect on the UK economy as UK monetary policy. He noted that there had been a big improvement in productivity growth in the UK: this growth had been of the order of 6-7% and had had the unfortunate side-effect of increasing unemployment.

5. On the prospects for inflation, Mr Davis said that he expected an average rate of inflation in the US of 5% in the period up to 1988, but this might be exceeded for a time in 1985. He expected that the decline in inflation would proceed in a ratchet process, in much the same way as the rise had come about. The dynamics of inflation would depend to some extent on the course of the dollar exchange rate. Sir Peter Middleton said that he did not expect that the change in the dollar exchange rate would be a major factor in determining the prospects for inflation. He thought that the great thing was for the US to manage the budget deficit (and trade deficit) in a non-inflationary manner. He was basically optimistic about the US economy, which had turned around after the lacklustre 1970s with good success in the 1980s in terms of both growth and jobs. Mr Davis commented that, as unemployment dropped, there was more scope to reduce public expenditure programmes and the deficit.

6. Mr Davis said that the prospects for tax reform were a subject of major debate within the JEC. In the JEC report on this subject, both the Democrats and the Republicans agreed on the need not to increase marginal income tax rates and the Republicans definitely favoured lower ones. He thought that the two main issues on tax reform were: (i) What is the optimal tax system given the level of taxes? and (ii) What is the optimal level of tax (or size of the State)? He thought it was important not to confuse tax reforms with a tax increase. There were suspicions that any reforms recommended by Secretary Regan would not be perfectly revenue-neutral.

7. Sir Peter Middleton said that, as far as the UK economy was concerned, growth had been at a rate of 3% since early 1981 and a gradual reduction in monetary growth and in the PSBR (expected to be 2½% of GDP by next year) had brought down inflation considerably. The first year or two of the Government's programme had been tough, but now that favourable results had been forthcoming the way ahead might be a little easier.

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8. Mr Davis said that he thought for practical purposes economic policy should be broadly divided into two parts. Fiscal policy should be used to determine the long-term structure and trends of the economy, and monetary policy to make adjustments around the trend. He thought it would be helpful to have more rules, and less discretion, in monetary policy so that the behaviour of the authorities would be more predictable. He was therefore on balance in favour of publishing the monthly minutes of the FOMC immediately after each meeting and in more detail than they were published now (although he did see some risks in publishing contingent policy statements). Sir Peter Middleton said that the UK Government's Medium Term Financial Strategy had been helpful in letting economic agents know where the Government was heading.

H G Walsh

13 April 1984

British Embassy
Washington

13/4/84.

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND MRS GAIL FOSLER, SENIOR ECONOMIST, SENATE BUDGET COMMITTEE, AT 2.00 P.M. ON 12 APRIL 1984

Mrs Fosler, in introducing a discussion of the US budget process, noted that the US executive branch had much less autocratic budgetary power than had the UK Government. The typical pattern was for the President to have a good deal of power over the budgetary process in the first year, but for the power to decay thereafter until he was left with little power in the fourth year. President Reagan was somewhat exceptional in that he still had a considerable amount of power with the Republicans if not the Democrats.

2. The history of the present Administration was that, when President Reagan came to power, he was helped by the large majority he gained in the election (and by the assassination attempt) in gaining support for his budget proposals. In his first year he was therefore able to make cuts in public expenditure which appeared at first to be going some way to reducing the budget deficit, although a year later it appeared that the budget deficit would be at $200 billion for the indefinite future. This prospect helped him secure reductions in 1982, even though this was a recession year. But 1983 was an extremely fractious year, and the budget process virtually broke down. The President took the view that his popularity was independent of progress on the budget deficit, and he attempted to blame it largely on the Congress. At that stage it appeared to some that the US Government had then divided into three groups: the President, the Republicans in the Senate and the Democrats. While the Administration made proposals in 1983 for spending cuts and a contingency tax increase, this was only a proposal. It had very little impetus and was not something that had much chance of being implemented. While the Congress passed a budget resolution with $73 billion of targeted budget reduction measures, the largest part of this was revenue enhancement and no tax legislation was in the end passed because the House got embroiled in a rules dispute towards the end of the year. Therefore the FY84 budget was only passed with savings of $17 billion instead of the intended $73 bn.

3. This year, stemming from no more than a staffer's last-minute suggestion for a sentence in a speech, the President included a proposal for $100 bn (over three years) "down payment" towards deficit reduction in his State of the Union Address . This had been taken up by the Senate Republicans, and a concordat had now been reached between

/them

them and the President. The procedure being followed to pass the downpayment legislation in the Senate was somewhat odd. A bill passed by the House of Representatives on small boats was being used as a basis on which to build up the structure of a complete tax bill. The tax bill would not be sent immediately for Presidential signature, but would be held and augmented by legislation embodying civil expenditure cuts. (The spending cuts, toegher with small provisions on agriculture and banking, would be recommended by the Senate Budget Committee and then joined to the tax bill on the Floor of the Senate.) The legislation would then be passed. Eventually, after all this had been done, there would be a budget resolution which would be consistent with the tax/spending legislation and also contain provisions for Appropriation ceilings and defence expenditure as agreed in the concordat. The Democrats had gone along with this arcane procedure so far, and it was therefore hoped that the deficit reduction package would be agreed in the Senate. (Mrs Fosler at one stage pointed out that the House had looser Parliamentary rules than the Senate!)

4. This would still leave the problem of the conference procedure with the House to reconcile the House version of the budget resolution with the Senate version. It was expected that the main problem would be the proposed ceilings on appropriations, which would probably be dropped in Conference. Since the Senate had built some fat into their budget resolution, the $100 bn in savings could well nonetheless be achieved.

H G Walsh

13 April 1984

British Embassy

Washington

13/4/84.

MEETING BETWEEN SIR PETER MIDDLETON AND MR. MARTIN FELDSTEIN - CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS ON 12 APRIL, 1984 AT 10.30 A.M.

1. Sir Peter Middleton opened the discussion and said that the UK economy was now growing steadily at 3% per year. The broad objectives of macro economic policy remained the same and the monetary aggregates were within their ranges. The recent UK budget had a surprisingly favourable acceptance. The UK had commenced a programme of tax reform, and this had been achieved without giving any large tax cuts this year.

2. Mr. Feldstein commented that the main reform seemed to be in taxation for the corporate sector. Sir Peter Middleton agreed adding that the changes were significant. The changes comprised a reduction in the capital allowances and a reductiion over a period of years in the rate of corporation tax. The package was designed to be revenue neutral, but the basic objective was to increase the rate of return by providing incentives for firms to invest in more profitable investments. Sir Peter Middleton added the UK was not under capitalised but the problem was to improve the productivity of capital. Mr. Feldstein said there was unlikely to be a supply side effect from cutting the rate of corporate tax on investment which had already been undertaken. If one wanted to be revenue neutral as well then one had to cut back on incentives for new investment.

3. Sir Peter Middleton hoped the change in company taxes would be followed by reforms affecting peronal taxes. Most countries' tax systems were complex, including that of the UK and it was difficult to make major changes at any one time. But it was essential to have broad objectives and implement a number of small changes over a period of years. His preference in approaching tax problems was to try and remove allowances and exemptions, enabling lower tax rates to be applied to a broader base. The Government had taken one step in the recent budget by abolishing the tax relief on premiums paid on new life insurance polices. The next step would be to consider moving to the much more difficult issue of tax relief on pensions and mortgages. Mr. Feldstein commented that altering rates of relief on mortgages was particularly difficult since it was an important political issue. Turning to pensions Sir Peter Middleton said the objective was to move towards greater equality in the tax treatment between those who provided for their own pensions and those who made contributions to pension schemes. Other issues included the relationship between private and state pension schemes and the need to improve the transferability of pensions. Mr. Feldstein said that one of the changes introduced by the Reagan Administration had been to provide more favourable tax treatment for pensions through the Keogh accounts for the self employed and the IRA accounts for individuals.

4. Mr. Feldstein asked about the UK experience with VAT, whether it had led to higher price expectations and the extent to which it had affected income distribution. Sir Peter Middleton commented that VAT had effectively replaced the old purchase tax. The main justification for such a tax was the ability to apply a low rate of tax to a wide variety of goods. In practice the UK had not achieved this since there were a number of important exemptions including transport, fuel, food. Accordingly the current rate at 15% was high, but necessary to achieve the revenue objective. The introduction

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of VAT may have led to some rounding up of prices, but it was a replacement for purchase tax and had been introduced at a time of rising inflation in the early 1970's. The introduction of VAT represented a tax increase for much of the population. Mr. Feldstein commented that he saw difficulties with such an approach in the US. There would almost certainly have to be exemptions for housing, medical care, education etc. and the greater the number of exemptions, the greater the distortions as demand was increased for these goods. If a broader based tax could be introduced, then it was likely to be strongly criticized in the US for being regressive.

5. Sir Peter Middleton commented that it was always difficult to introduce new tax measures. He knew Mr. Feldstein preferred a consumption tax, but it was unlikely the basic system of income tax could be transferred to a consumption tax quickly. Secondly, it was also difficult to make a progressive income tax system broad based. One had to move in small steps and it was easiest at the start of an administration.

6. Mr. Feldstein asked why thresholds existed for capital gains tax in the UK. Sir Peter Middleton replied that there was always a trade off between the amount of revenue raised and the costs of tax collection. Mr. Feldstein replied that the US had no exemptions on their capital gains tax, but since individuals were responsible for assessing their tax liability, the costs fell on them.

7. Turning to the US economy Mr. Feldstein said that he hoped for 5% GNP growth throughout 1984 and 5% inflation. This implied some moderation in the growth of the economy. He was encouraged at the progress made on reducing the budget deficit. The tax bills in both the House and the Senate were very similar. There was also agreement in Congress on the size of the spending cuts to be achieved. But differences clearly existed on the appropriate mix between defence and non-defence spending.

8. Sir Peter Middleton said the size of the budget deficit remained a concern, but he detected some movement in the US Treasury view. Mr. Feldstein commented that he had been trying to persuade the Treasury to drop their arguments on the lack of any relationship between deficits and interest rates, partly because they were wrong and partly because there was some evidence that cuts in the deficit would be achieved. This was a more positive argument.

9. Sir Peter Middleton commented on the size of capital inflows into the US and the problem of the US moving into a net debtor position. Mr. Feldstein said it was also a matter of concern to him, although without the inflows interest rates would be higher and the pressures on the Fed to pursue an easier monetary policy would be greater.

10. At this point Mr. Feldstein was called away to another meeting, but ended by saying that he was reasonably confident about the prospects for the economy. There was now only a limited amount of time for the Fed, should it decide to tighten monetary policy, to take actions which could adversely affect the economy before November.

11. The meeting ended at 11.20 a.m.

J J M EXETER
13 April, 1984

13/4/84

MEETING WITH MR. ROBERT ORTNER, CHIEF ECONOMIST
DEPARTMENT OF COMMERCE ON 11 APRIL, 1984 AT 4.15 P.M.

1. Sir P. Middleton asked Mr. Ortner for his view on the strength of the recovery. Mr. Ortner replied that the flash estimate of 7.2% growth in the first quarter had been surprisingly strong, but it was likely that many of the indicators due to be released at the end of the week would show more moderate growth. One indication of this was the small decline in the indicators of aggregate weekly hours which in his view was a reliable indicator of industrial production. Industrial production in March would therefore not necessarily fall, but it was likely to be moderate. Other indicators of moderate growth were low auto production and lower auto sales. Housing starts had surged in the first two months of the year, but this was an increase from a low base. In general it appeared that much of the activity in the first quarter had been concentrated in January alone.

2. Mr. Ortner added that some of the series had been rather erratic because of problems with the seasonal adjustment factors. Sir Peter Middleton replied he was well aware of some of these problems. He had been reviewing series in the UK where some of the seasonally adjusted numbers had been more erratic than the unadjusted numbers.

3. Sir Peter Middleton asked whether Mr. Ortner was concerned over the prospects of inflation in view of the current stength of the economy. He added that those he had met on Wall Street seemed very concerned about inflation and interest rates. Mr. Ortner replied that there had been a small increase in inflation, but the prospects remained favourable. The test would come in the summer when the auto workers negotiated a wage settlement. Their slogan was "restore and more". The high level of car company profits made it likely that the auto workers would succeed in restoring previous wage concessions, but much depended on how big a wage increase they secured over and above this. In general, the Administration was content with the strength of the expansion. Profitability had risen, companies' cash flow had improved and the outlook for inflation was reasonable.

4. Sir Peter Middleton had asked whether protectionist pressures had eased to any extent in view of the extent of the recovery. There was always a danger that each world recovery would commence with more trade restrictions than before. Mr. Ortner replied that it was possible the pressures were no greater than before. But local content legislation was still being considered by Congress. In his view the House of Representatives had passed the bill since it represented an easy option in an election year, but this was irresponsible as they were hoping the Senate would reject it. There was of course no guarantee this would happen. The steel industry was the most persistent in arguing for more quotas. Sir Peter Middleton added that the UK had made huge reductions in its own steel capacity.

5. Sir Peter Middleton commented on the dollar exchange rate saying that in his view there would only be a gradual fall in the value of the dollar. A combination of a large US budget deficit and firm monetary policy would mean that US interest rates would remain high and would therefore limit the extent of any fall in the dollar. But the large trade deficit was a problem and there were

clearly doubts as to how long it could be sustained because of the size of capital inflows. Mr. Ortner said he shared Sir Peter Middleton's concerns. He added there was a danger that the current account deficit would deteriorate further because of the high interest payments the US would have to pay on much of the portfolio investment. This would reduce the size of the traditional surplus on invisibles. In this sense there was some analogy with the problem of higher interest charges on the budget deficit.

6. Mr. Ortner said there were two main problems facing the economy. One was the possibility that the exchange rate could fall much faster than he expected. The trade deficit had amounted to almost $20 bn in the first two months of the year and was likely to exceed $100 bn in 1984. Secondly, there was the problem of the large budget deficit. The high level of real interest rates reflected the market's concern that some of the deficit might be monetised. His own Department had recently completed some internal work on the relationship between deficits and interest rates. They had found some relationship, although it was not stable over time. Sir Peter Middleton said there must be some relationship, although there was a danger of relying too much on econometric evidence to prove a particular point. If the Government ran a large budget deficit then it would need to create financial assets which the market would have to purchase. If the market also believed there was some chance that part of the deficit might be monitised, then higher real and nominal interest rates were inevitable. He added that the UK was now in the rather unusual position of having lower real and nominal interest rates than the US.

7. The meeting ended at 4.50 p.m.

J J M EXETER
13 April, 1984

13/4/84.

cc: PS/Chancellor
Sir Peter Middleton
Mr. Littler
Mr. Unwin
Mr. Lavelle
Mr. Walsh

RECORD OF MEETING HELD AT THE US TREASURY, WASHINGTON DC ON TUESDAY, APRIL 10, 1984, AT 5.15 PM

Present:

Dr. Beryl Sprinkel, Under Secretary for Monetary Affairs
Mr. David Mulford, Assistant Secretary, International Affairs
Mr. Charles Dallara, Deputy Assistant Secretary, Monetary Affairs
Ms. Margot Machol, Special Assistant to Dr. Sprinkel
Ms. Helen Walsh, UK Desk Officer

Sir Peter Middleton
Mr. N.L. Wicks

US Economy

1. Dr. Sprinkel, in euphoric mood and to hardly concealed mirth of some of this colleagues, said that the US economy was progressing magnificantly. The 7.2 per cent annual growth rate recorded for the first quarter was likely to be revised up, though the second quarter figure would probably turn out at about 4-5 per cent. Monetary policy ought to be capable of being kept on target, though it was not beyond the Fed's capacity to muck things up. An 8 per cent rate of monetary growth was certainly high enough.

2. Sir Peter Middleton said that it was important to keep US inflation under control. He hoped that this could be achieved at lower interest rates. Dr. Sprinkel commented that two years had been lost in the battle against inflation by the Fed's massive monetary infusion between August 1982 and March 1983. This had been intended to keep interest rates down so as to help the debtor countries. The outcome had been the very reverse.

3. Dr. Sprinkel recalled the Administration's long standing difference of view with the British Government about the US deficit and the British's Government's advice that the Administration should be urged to contemplate tax increases if this was the only way to reduce the deficit. Sir Peter said that the British Government certainly did not believe in raising taxes. Expenditure reduction was

the crucial area. But the size of the US deficit was nevertheless extremely disturbing for the development of the world economy. Dr. Sprinkel agreed that the deficit was too high. He did not agree with those who argued, for example, that the deficit preempted too large a proportion of savings. There were a lot of other flows through the capital markets besides savings, such as depreciation (sic). Dr. Sprinkel recalled that pessimists had argued that because US interest rates were high, there would be no recovery; or that if there was a recovery it would be distorted. They had been proved wrong. They were also wrong in arguing that the high budget deficit was the prime cause of high interest rates. Sir Peter emphasised that it was important for the world economy that US inflation be kept under control. Dr. Sprinkel, agreeing, said that the President's deficit reduction budget was making good progress on the Hill. There was a good prospect that a three-year down payment of $150-180 million would be agreed in the next month or so. If the President won the election, the Administration would obviously have to return to the battle.

The European Economy

4. Dr. Sprinkel then asked about the prospects for reducing unemployment in Europe, particularly in the UK. Sir Peter said that there was substantial agreement that the remedy lay, not in macro economic policy, but in measures to improve the supply side of the economy, particularly the functioning of the labour market. Real wages were increasing too fast. This was not reflected in proportionately high unit cost growth because of the significant improvement in UK productivity. It was unfortunate that labour market adjustment in the UK was being made through unemployment rather than thought restraint of real wages. Dr. Sprinkel said that Europeans were paid too much and that employment was discouraged because of the costs of redundancy. Sir Peter pointed out that it cost an employer virtually as much to employ an unskilled teenager as an experienced worker. Dr. Sprinkel observed that if unemployment remained high in Europe, there could well be pressure in time to come for reflation. It was therefore all the more important to pursue structural adjustment. This should be a theme for the Summit. Sir Peter agreed.

UK Economy

4. Dr. Sprinkel, after recalling that a miners' strike had brought down Mr. Heath's Government, asked about the present coal strike. Sir Peter explained why the present situation in the mining industry was quite different to that under Mr. Heath's Government.

5. Dr. Sprinkel then commented that while some Northern European economies gave rise to concern, many countries in Europe, including the UK, appeared to be growing satisfactorily.

6. Dr. Sprinkel enquired about the differing GNP figures for the UK. Sir Peter said this was a reflection of data collection problems,

/the growth

the growth of the underground economy, and the changing structure of the economy.

7. Referring to the changes in company taxation in the recent budget, Sir Peter said that he was increasingly coming to the view that for economic and budgetary purposes tax relief should be considered in the same way as public expenditure. Dr. Sprinkel recalled that the President had asked Secretary Regan to consider reform of certain parts of the tax structure. This had Democratic support, and there were good prospects of progress if the President won the election.

OECD Secretary General

9. Dr. Sprinkel explained that the Administration had decided to support Paye's candidacy as Secretary General in order to avoid the appointment of Ortoli or de Clercq. He hoped that Ken Couzens candidacy would be kept in the ring.

10. On OECD work generally, Sir Peter said that despite van Lennep's speeches, the OECD economic staff did not devote enough time to supply side matters. Dr. Sprinkel strongly agreed. He had suggested some good economists as OECD staff members, but had always been rebuffed. He undertook to speak to Mr. Littler about the possibility of lobbying the support of G5 Deputies for good candidates for the OECD staff.

11. The meeting closed at 6 pm.

N.L. Wicks
Washington DC
April 13, 1984

14/4/84

cc: PS/Chancellor
Sir Peter Middleton
Mr. Littler
Mr. Unwin
Mr. Lavelle
Mr. Walsh

RECORD OF MEETING HELD AT THE WORLD BANK, WASHINGTON DC
ON THURSDAY, APRIL 12, 1984, AT 4 PM

Present:

Mr. Tom Clausen, President	Sir Peter Middleton
Mr. Moeen Qureshi, Senior Vice President	Mr. N.L. Wicks

1. In answer to a question from Sir Peter Middleton, Mr. Clausen said that he was sure that prosperity could be restored to the world economy if economic fundamentals were put right. Progress was being made, even in Sub-Saharan Africa. For example, Madagascar, Sudan and Ethiopia were now tackling long-overdue problems. Mr. Wicks added that Ghana fell in this category too. Mr. Clausen agreed, and noted that Mr. Rawlings was now giving more support to the economic policies of his Prime Minister and Finance Minister.

2. Mr. Clausen said that the 1970s had seen US support for multilateral action, but in the 1980s they were putting more emphasis on policies. Sir Peter Middleton emphasised the British Government's support for the multilateral financial institutions. Mr. Clausen then paid a tribute to the UK's role in the World Bank, recalling that the Prime Minister had broken the log-jam on IDA 6. He also noted the Bank's increasing access to the UK capital markets. Sir Peter, recalling the conversation at his lunch with Fund and Bank officials the previous day, said that he would look again at the raison d'etre for the queue when he returned to London.

3. Sir Peter Middleton said that he had some confidence that economic growth would continue. Mr. Clausen asked whether he had the same confidence about the containment of protectionism. Sir Peter was less confident here and told Mr. Clausen about the work of the OECD Committee which he chaired. It was always disappointing that too many countries insisted on some escape clause when agreeing to robust declarations against protectionism. But there was a mood to be caught. The drive against protectionism needed to be kept on the agenda and continuing pressure applied. It was also important to press for transparency in trade matters. Mr. Clausen strongly agreed, and cited the Bank's recent success in persuading Brazil to display certain subsidies openly in their Budget.

/4. Mr. Clausen

4. Mr. Clausen reviewed with Sir Peter the current state of play on the IDA 7 and SCI negotiations.

Merit Pay

5. Sir Peter enquired about the Bank's system for merit pay. Mr.Clausen said that some 65 per cent of pay increases were used for merit increases, with the balance split on an index basis. The Bank Executive Board agreed the general policy of the merit pay. It was up to Management to implement the system. The merit allowance was allotted to managers for distribution on a budget basis. Mr. Qureshi said that managers had some discretion to allot the merit increases but within guidelines, e.g. to keep individual staff salaries within defined ranges. Mr. Clausen noted that the Fund did not operate such a developed system of merit pay. The Bank Staff attitude surveys had suggested that, after some initial doubts, the Staff were now recognising the benefit of the merit pay system.

6. The meeting closed at 4.35 pm.

N.L.W.

N.L. Wicks
Washington DC
April 14, 1984

pnp

SIR PETER MIDDLETON'S VISIT TO WASHINGTON
9-12 APRIL 1984

/ Attached are the notes on Sir Peter Middleton's calls on US officials during his visit to Washington from 9 - 12 April.

N.L.W

N L Wicks

18 April 1984

Encs: 15

c. PS/Chancellor
Sir Peter Middleton
Mr Littler
Mr Unwin
Mr Lavelle

12/4/84

NOTE OF A MEETING BETWEEN SIR PETER MIDDLETON AND DR DEVINE, DIRECTOR, OFFICE OF PERSONNEL MANAGEMENT, AT 2.00 P.M. ON 10 APRIL 1984

Sir Peter Middleton commented that, now that the UK budget was out of the way, he could turn his mind to Civil Service matters. In the drive for improved Civil Service efficiency in the UK, one of the current ideas was the introduction of merit pay. Dr Devine said that, at an OECD conference in 1981, he remembered that the US and Canadian representatives were in favour of merit pay, the Continentals were opposed, and that the British were willing to listen to both sides. He had seen a proposal to implement merit pay emerge in the report of the Megaw Commission, but he did not know how the proposal had fared in the UK.

2. Sir Peter Middleton said that the UK was seriously considering introducing a merit pay system. It was most likely to begin at a relatively senior level and take the form of bonuses. Dr Devine said that the original US Civil Service Reform Act had provided for bonuses for senior managers and merit pay for middle management. The scheme for senior managers had been the more successful since the General Accounting Office had removed 40% of the bonus pool for middle management by interpreting the Statute more rigidly than had OPM. The scheme for senior managers had provided for up to 50% of them to receive a bonus in any given year, and in the first year exactly 50% received them. A suspicious Congress had changed the maximum limit to 25% and his predecessor by regulation had reduced it further to 20%, a reduction which was then embodied in law by a rider of the Congress. The rider had expired in the previous year. (He believed that the ideal percentage was 30%.) A further Congressional complication had now arisen: the Congress was blocking new moves to extend pay for performance to the middle ranks. The US Civil Service unions were very powerful and they tended to work through Congressmen who represented constituencies close to Washington. He had underestimated the power of the unions in his first few months of office. Sir Peter Middleton commented that UK Civil Servants had very little political power, basically because they were not numerous and had no support in the community or from the Parliament.

3. Dr Devine commented that he had made funds available for bonus pools by collapsing salary scales and putting the proceeds into the pool. On an experimental basis on the West Coast, grade levels also

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