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PM's meetings with Mr Paul Volcker, Secretary of the Federal Reserve Bank

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PRIME MINISTER

January 1981

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10 DOWNING STREET

From the Principal Private Secretary

13 December, 1984.

Dear David,

The Prime Minister met Chairman Paul Volcker this evening. He was accompanied by the US Ambassador and Mr. Jerry Newman.

The Prime Minister started off by asking Mr. Volcker about the banking situation in the US, including the possibility of further problems for the US banks if growth slowed down in the US economy. Mr. Volcker said that the US banks had assumed that inflation would last for ever, and were staffed by people who had not the experience of the late '20s and '30s. There could be further difficulties. He would not let major banks go under without a struggle, but believed that the stockholders should suffer as they had done in the case of Continental Illinois.

The Prime Minister commented that she had heard that recent appointments to the Fed Board were not proponents of such strict monetary discipline as Mr. Volcker himself. Mr. Volcker said that he would confine himself to the comments that the last two appointees had been known to dissent from recent decisions on the side of easier money. He also said that, while he had been in Europe, he had read a report in the New York Times that the Secretary of the US Treasury had criticised the Fed for pursuing an "irresponsibly tight" monetary policy. The Prime Minister commented that she saw Mr. Volcker's personal role at the Fed as vital.

The Prime Minister then asked Mr. Volcker how he saw the prospects for US growth. Mr. Volcker said that he saw a risky period ahead. Part of the problem was a "blip" which was natural after recent rapid growth as inventories got out of line. But the real problem he saw was the rapid rise of imports. This was partly due to rapid growth and partly to the high dollar. But the consequence was that US manufacturers were being undercut, and there was much greater uncertainty and reluctance to undertake investment. Another consequence was that too much of the income generated by US economic growth was taking place abroad. He thought that there would be a slowing down in the US economy next year, and he hoped that Europe and Japan would take up the running. Prime Minister Nakasone was visiting Washington in January, and a Japanese banker had urged that he should be put under as much pressure as possible to expand the Japanese domestic economy. Germany was probably

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also capable of more internal expansion. The Prime Minister said that she was not optimistic about making the Japanese change their ways.

The Prime Minister said that she thought one of the main reasons for the strength of the dollar was that the US was a reliable free enterprise economy. She wondered therefore why the US had to pay such high interest rates for its borrowings. Mr. Volcker said that, unlike the Swiss, the US did not have 20 years of sound monetary policy behind them, although he hoped that as a result of their performance in the last 5 years they now had more flexibility than 3 years ago. But the main problem was that total savings were 8½% of national income, whereas borrowing was 11%.

The Prime Minister then asked about the US deficit. She was concerned at the rate at which the proportion of revenue represented by debt interest was growing, and she understood that the US was about to become a debtor nation. It had been suggested to her that the President might do a deal with Congress by which he agreed to equivalent increases in revenue in return for Congress's agreement to cuts in public expenditure and a constitutional amendment for a balanced budget. Mr. Volcker said that he had not heard this particular suggestion before. The President was not far from being able to get an amendment for a balanced budget through Congress - it would probably already pass through the Senate - but he did not think that it would have particular significance. The US was already a debtor nation on some counts, and in the next 2 years would beome much more so. Nothing could be done about the internal deficit for at least a year. The US growth had so far been beneficial both to the rest of the world, and to the US itself: the problem was that the combination of external and internal deficits could not last.

The Prime Minister asked Mr. Volcker his views on the international banking situation. Mr. Volcker said that there were many new faces among the central bankers, particularly in the major countries. He would miss Fritz Leutweiler very much. As regards the international situation, he hoped that the Prime Minister would be sympathetic over Argentina. He accepted her view that the Argentines might have got an easier deal than they should have done, but it was still essential that support should continue. He thought that Brazil had done particularly well in improving its balance of payments, and he had some hopes for Venezuela. But he was worried that Mexico was showing signs of lapsing into old ways: certainly there was no opening up of the Mexican economy.

The Prime Minister said that the only course forward that she could see was to try to run things prudently, and to go in the right direction slightly faster than people thought that they could accept. Mr. Volcker said that it was vital that the Government should not be defeated by the

mineworkers' strike: the action which President Reagan had taken over air traffic controllers early in his first Administration had been crucial in changing attitudes throughout the US economy.

I am sending a copy of this letter to Len Appleyard (Foreign and Commonwealth Office).

Yours ever,

Robin Butler

David Peretz, Esq.,
HM Treasury.

PRIME MINISTER

MEETING WITH MR. VOLCKER

It is probably logical to start with the US economy and its implications for the deficit and the dollar, then go on to the deficit and what can be done about it, and finally to the banking system. Attached is a note by Alan Walters and a summary of the prospects for the US deficit.

US Economy, the Dollar and Interest Rates

- What lies behind the present slow-down? What does Mr. Volcker expect growth to be next year? (He will say zero at worst and 3% at best).

- What impact is the high dollar having on US industry?

- Is high growth financed by savings from abroad sustainable?

- Can a soft landing for the dollar be achieved or will it plummet, requiring high interest rates to break its fall? (Mr. Volcker hopes that if moderate falls in interest rates and the deficit are achieved, Germany and Japan will adopt more expansionary policies).

US Deficit

- If growth slows down, what will be the impact on the deficit?

- Is the President concerned about the deficit or only about public expenditure? (He is likely to say the latter and that the President will resist tax increases strongly, preferring to seek public expenditure cuts in the first instance).

- What does he think is the best way to approach the President on the deficit? Should you argue directly for tax increases, make the point obliquely by reference to UK policy where deficit reduction required action on both sides, or should you leave the President to tackle the deficit in his own way?

Banking System

- Is Mr. Volcker concerned about the domestic portfolios of US banks if activity slows or oil prices fall?

- Is he confident about the ability of the US authorities to handle any difficulties?

- What lessons can be learnt from the Continental Illinois case?

International Debt

- Is there any alternative to the present case by case approach?

- How does he view progress on the debt packages initiated with Brazil, Mexico and Argentina?

- Are the IMF programmes associated with them being acted upon?

AT

Andrew Turnbull
12 December 1984

12 December 1984

PRIME MINISTER

VOLCKER MEETING
US DEFICIT AND THE TREASURY'S "PROPOSALS"

The Stockman spending cuts of $240bn over three years will surely be mangled by Congress and departments. I doubt if more than $100-130bn will emerge - and then they will not be effective before 1986 at the earliest. The annual effect - say $40bn a year - will not offset the increase in the forecast deficit due to slower growth.

Supply siders (eg Paul Craig Roberts) blame the larger deficits on Volcker's slow monetary growth in the last five months, which has dampened down the expansion from 8% in 1983-4 (ii) to 1½ to 2 percent in the second half of 1984. (Volcker is likely to say that the M1 aggregate is very distorted by regulation changes etc.)

Increases in taxes (the "last resort") are now being openly discussed even in the White House, but again even if sanctioned by President and Congress it will be a long time before it falls on pocket books - 1986 at the earliest. And if a downturn or even slow growth has occurred the reluctance to increase taxes will be increased.

In my view there is as yet insufficient commitment and momentum to secure credibility of any programme produced by either the Administration or Congress. The President still hopes that Congress will yield to the expenditure cuts. A possible compromise would be for the President to accept a one-for-one tax increase and expenditure cut provided that Congress agrees to a constitutional amendment to provide for a balanced budget.

Monetary Policy

The Fed is not trying to maintain interest rates mainly because of their fears of a slower growth rate and the accusation that it was Fed-induced. In effect there has been a decline in the demand for credit by the private sector as the investment boon, induced by the tax remissions of 1981/2, has begun to peter out, and interest rates have declined up to two percentage points.

The Fed board has become rather more expansion and supply-side minded with the appointment of Martha Seger. She joins Preston Martin, Volcker's deputy, and another Reagan appointee, to give the expansionist group more voting power. Conjectures are rife about the possible resignation of Volcker in 1985 and the promotion of Martin. (This would be quite devastating to confidence in the Fed, but I am not sure that the President is receiving such advice. An acceptable alternative would be Alan Greenspan but he is disliked by the supply-siders, who influence the President.)

The Debt Problem

i. International

As we feared, the short term liquidity rescue has lulled many into a false sense of security. There has been very little action on the institutional side with long term reforms to put matters right.

We have wasted time - and now time may waste us.

[Fritz Leutwieler was present at the Argentine negotiations and was infuriated by the behaviour of the Central Banks, the Fed, the IMF and the Bank in the arm-twisting. The Argentinians made noises as usual.]

The trade surpluses of the debtor countries hinge entirely on the US current account deficit of $120bn or so, which is quite unsustainable both politically (through protectionist pressures) and economically.

These transitory surpluses have given excuses for delaying the painful long term adjustment process and the western banks have used them as excuses for more credit to pursue the fiction that the loans are "performing".

ii. Domestic bank debt in the United States

As we saw in Continental, the domestic porfolios are even more worrying - especially in energy, agriculture and heavy industry. A downturn in the economy will give cruel exposure of their fictions. Too little has been done to liquify and rebuild their balance sheets.

In sum, I fear a major collapse - say of two money centre banks such as Manufacturers and Chase. How will Volcker (or Martin, God forbid!) handle this massive loss of confidence? Are they prepared for such a contingency? The depressing effect of a flight from bank deposits could be horrendous.

A warning note appeared in the Continental case when the FDIC's promise (probabbly unconstitutional) to bail out all depositors did not stem the attrition at all.

We know the lessons of the 1931 collapse, but now the size of the problem is so much larger and the international linkages so much more complex.

The massive supply of liquidity needed to offset such bank runs will have to be withdrawn quickly as the situation is restored - otherwise we will find the unsavoury combination of inflation and depression overtaking events.

ALAN WALTERS

PROSPECTS FOR THE US BUDGET DEFICIT

1. Summary

(i) The US Federal budget deficit in Fiscal Year 1984 was about $175 billion, and could on present policies rise to $260 billion (remaining at 5% of GNP) by FY 89. The structural budget deficit may rise from about $110 billion (2.9% of GNP) to about $250 billion (4.6% of GNP) in the same period. The budget deficit is not out of control, but has been exacerbated by the 1981 tax reductions, the defence build up, and rising debt service costs. (Paragraphs 2 and 4.)

(ii) The amount of public debt outstanding in the US on present policies could double between 1983 and 1989, and interest payments, now at $300 million a day, could reach over 20% of tax receipts by FY 89. (Paragraph 2.)

(iii) Recent economic and political developments have made it harder to form a deficit-reducing coalition. The vital relationship between the President and the Republican Senate leadership may not be as close as before. Cooperation from the Democrats on budget issues is unlikely, since they are still smarting from the effects of their election defeat. (Paragraphs 3-7.)

(iv) The President is likely, in his FY 86 budget proposals, to concentrate almost exclusively on expenditure reductions, perhaps with the objective of reducing the deficit to $100 billion or 2% of GNP by 1988. (Paragraphs 8 and 9.)

(v) The possible outcomes include no action until 1986, or a freeze on expenditure increases this year. The actual outcome will depend on whether the Congress are galvanised into action. (Paragraphs 10 and 11.)

(vi) The Treasury Department's proposals for tax reform are an attractive package, but their prospects are dubious,for they would harm important special interests, and are irrelevant to the main budget issue. The proposals if implemented would probably tend to reduce US interes rates. (Paragraphs 12-15.)

(vii) The Congressional budget process will probably not be reformed this year, but dissatisfaction with the present procedure is growing. (Paragraphs 16 and 17.)

(viii) We should continue to put firmly on record our view that the Federal budget deficit is too large. But we also need in private to suggest to the Administration, and especially influential Congressmen, that the US should adopt a medium-term financial strategy similar to ours, with targets for a phased reduction of the deficit. (Paragraphs 18 and 19.)

(ix) If a consensus for firm action develops, and entrenched positions are relaxed, progress could be rapid. Butthe firm commitment of the President to any compromise would be essential, and there is no sign at this stage that he is willing to make one. (Paragraph 20.)

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Treasury Chambers, Parliament Street, SW1P 3AG
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12 December 1984

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

VISIT OF PAUL VOLCKER

The FCO are preparing, in consultation with the Treasury, briefing on the world economy and US economic prospects for the Camp David talks. More immediately you may like to have, as background for the Volcker meeting, the attached summary note on the US economy.

In recent days, as you may have seen, Volcker has made two major speeches - on debt and the US growth. The attached excerpts may also be of interest. For completeness I am also attaching Oliver Wright's recent despatch on the US prospects as seen by the Embassy.

The Chancellor is himself seeing Chairman Volcker later today, and I will let you know any major points of interest that come up.

Yours ever
David

D L C PERETZ
Principal Private Secretary

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Economic and Fiscal Background

2. The table below provides the latest Congressional Budget Office projections for the main budget aggregates up to FY 89 if no corrective action is taken. The economic growth assumptions underlying the figures are: 6.6% in 1984, 2.8% in 1985 and 3.1% thereafter. The deficits forecast are high but do not seem to be unrealistic. The CBO budget deficit forecast for FY 85, at $178 billion, is well below the Administration's latest forecast of $205-210 billion; the Administration forecast for later years will probably not be known until the budget is published in January.

US BUDGET: CBO AUGUST BASELINE

(Fiscal years, $ Billion or %)

	Actual	Projected				
	1984	1985	1986	1987	1988	1989
Revenues	666.5	751	811	881	965	1042
Outlays	841.8	929	1006	1097	1203	1305
Deficit	175.3	178	195	216	238	263
Cyclical Deficit	67	32	28	20	17	17
Structural Deficit *	108	146	167	195	221	246
Per cent of GNP:						
Revenues	18.6	19.1	19.1	19.2	19.4	19.4
Outlays	23.5	23.7	23.7	23.9	24.2	24.3
Deficit	4.9	4.5	4.6	4.7	4.8	4.9
Cyclical Deficit	1.9	0.8	0.7	0.4	0.3	0.3
Structural Deficit	2.9	3.6	3.9	4.2	4.4	4.6
Debt in Hands of Public	1,308	1,497	1,706	1,936	2,189	2,466
Net Interest on Debt	111.1	133.5	149.6	168.6	194.1	213.9
Net Interest as % of Revenues	16.6	17.8	13.4	19.1	20.1	20.5

* at 6% unemployment

3. There seems to be a consensus - probably now extending to President Reagan - that the structural budget deficit is a serious problem. Financiers are concerned at the deficit's implications for US Treasury borrowing, and the resulting crowding-out of the credit markets. Farmers and producers of tradeable manufactures recognise high interest rates as the main cause of the high dollar and low exports, and are consequently generally sympathetic to deficit-reduction measures. There is a traditional Republican concern to see the country back on a sound fiscal basis, and a new Republican desire to put an end to big government. Insiders such as Niskanen, of the Council of Economic Advisers, and Penner, of the CBO, fear most the recent explosive rise in public debt, since the Federal Government now pays $300 million a day in debt service, and the number is rising fast. But the consensus that a high deficit is bad news falls a long way short of agreement on how to remedy it.

4. Part of the problem is that the causes of the deficit are not widely understood. In the last ten years, the rise in the deficit correlates with the rapid rise in non-means-tested entitlement spending from about 7% to 10% of full-employment GNP. But such expenditure is financed by Social Security taxes which are regarded by most Americans not as taxation but as insurance premia. These insurance premia have fully financed the increase in entitlement expenditure, and have not directly contributed to the deficit. Growth in discretionary

expenditure and expenditure on "welfare" (ie means-tested social programmes) has not grown disproportionately, especially since this expenditure was severely cut in 1981. Income tax, to be indexed only in this tax year, has been a buoyant source of revenue because of the combined effects of inflation and a progressive rate structure. There has been a significant decline in the contribution to revenue of the corporate income, estate and gift taxes (5.6% of revenue in 1970; an estimated 3.0% in 1984). But, especially from the perspective of the period since 1980, the growth of the defence budget and the tax reductions of the 1981 Economic Recovery Act (ERTA) have been the main causes of the deficit. To that extent the deficit reflects specific acts of policy and (aside from debt interest) is not "out of control". But it is obviously not easy for the Administration either to reverse previous policies or to withdraw benefits from millions of Americans.

The Congress

5. The situation in the Congress is also more difficult than before. The significant point is not that the election brought net gains of two for the Democrats in the Senate and fifteen or sixteen for the Republicans in the House of Representatives. The Senate before the elections already contained a handful of Republicans who regularly voted with the Democrats on economic issues. The new Senate could well be considerably more centrist and less conservative than its

predecessor and the new majority leader, Senator Dole, will be significantly less inclined to take his instructions from the White House than was his predecessor, Howard Baker. This could mean more consensus within the Senate, but also that the vital relationship between the President and the Republican leadership will be weaker. But Dole has said that he wants to give precedence to the deficit issue and seems to favour a spending freeze.

6. The House will still contain a substantial Democratic majority, but may be rather more conservative than its predecessor. The thirty-two new Republicans who have entered on Reagan's coat-tails could join up with the other Young Turks led by Jack Kemp of New York. If so, compromises between the Democrats and the Republicans in the House will be difficult to achieve and the mere existence of so many advocates of supply-side economics could lead the President to be cautious in agreeing to compromises embodying tax increases. The minority Republican leadership in the House could therefore have a difficult balancing act to maintain a common Republican front while attempting to reach a budget compromise with uncooperative Democrats.

7. The prospects for early action on the budget deficit are not likely to be helped by developments in the economy. If the low (1.9%) annualised rate of growth of the third quarter of 1984 continues and unemployment should begin to rise, then old-fashioned Keynesians and supply-siders in Congress could

form an unholy alliance to block a deficit-cutting compromise. Measures to increase expenditure on countering unemployment might even have some chance of being passed. If growth resumes at a non-inflationary rate of 3% next year, then the Congress will have little incentive to take any action, particularly if interest rates remain constant or continue to fall. If strong growth resumes, then the recorded deficit will not be below forecast, and no action would be likely unless interest rates also rose sharply. Congress might be galvanised into action by a crisis, such as a collapse of confidence in the US dollar or a large fall in stock or bond prices and a rise in interest rates. But these would be chance events, and there is no certainty about whether or when they might arise.

Expenditure Reductions

8. The FY 86 Budget (for the year beginning in October 1985) has not yet been finalised by the President, but on the basis of the usual leaks, and discussions with officials and Congressional staffers, it is possible to speculate about the expenditure reduction propoals it will contain. During the election campaign the President appeared to rule out tax increases (by degrees ranging from "only as a last resort" to "over my dead body"), and this undertaking will certainly apply to his own budget proposals. Therefore the budget to be published next January will be largely confined to proposals for expenditure reductions. To use the words of Administration

insiders, they are likely to be Draconian. Since only about 18% of Federal expenditure is on non-defence discretionary items, any substantial proposals for cuts will have to make inroads into controversial entitlement areas such as Medicare. But it is not expected that the Administration will again attempt to make major cuts in means-tested programmes, which affect the poor, as it did in 1981. The main areas now being canvassed for cuts include:

- Civil Service retirement benefits
- Grants to State and local governments
- Veterans' benefits
- Medicare and Medicaid
- Tax deductions for medical expenditure
- Agricultural support
- Perhaps, abolition of the Department of Education or even the Ex-Im Bank.

The above is not an exhaustive list, and areas such as defence are likely also to be targeted by Budget Director Stockman. There seem to be signs of a possible consensus that Weinberger's budget request will be cut back to 5% real growth. The only expenditure programme likely to be immune, because of the President's campaign promises, is Social Security.

9. The Administration's objective is likely to be to reduce the budget deficit to $100 billion, or 2% of GNP, by 1988. This would also stabilise the public debt/GNP ratio, and

prevent interest costs from soaring. To do this by expenditure reductions alone would require a remarkable success in Congress, since proposals for cuts in the target areas will obviously evoke strong protests. The precedent of 1981 is often cited, and the President then secured $35 billion of expenditure cuts. But the 1981 tax reductions were greater, so the analogy is imprecise. In the end, the President may reject Budget Director Stockman's advice, and simply propose that expenditure be frozen at current nominal levels. Senator Dole is said to favour such a scheme, and it would avoid some of the conflicts about particular areas for cuts, but it would still constitute a Draconian proposal.

10. The support of at least some Democrats would be necessary to enact any programme of expenditure reductions. But the Democrats are at present not inclined to be co-operative. As they see it, President Reagan minimized the importance of the deficit during the election campaign, and claimed that the deficit would be reduced by recovery, whereas they took what they regard as a more responsible approach and recommended a tax increase; lost in consequence. They now regard the deficit as the President's problem: let him either cure it by delivering on his promises of growth, or admit his mistake, and go for tax increases.

Budget proposals for FY 86, focusing on expenditure cuts alone, may therefore not get very far in a Congress that shows no more signs of being tougher on expenditure than was its predecessor.

11. The Democrats will have to be mollified by tax increases, and it is not clear that many of the new Republicans in the House of Representatives will wish to compromise with them. As noted in paragraph 6, a compromise might therefore depend on skilful leadership within the Republican caucus in the House before the Democrats are even approached. Optimists here say that there could be negotiations next July or August for a package to supplement the "down-payment" that was finally agreed in October of this year. But the majority view is that such a compromise will be difficult to reach, short of a financial emergency. If an emergency were to occur, it would make it more probable that agreement could be reached on a spending freeze at current levels.

Tax Reform

12. The President has now received a report containing proposals from the US Treasury for a revenue-neutral package of tax reforms. The proposals as they stand are strictly irrelevant to the budget deficit, being revenue-neutral. They will probably not be seriously considered for passage by the Congress until after the first attempt at passing a Budget Resolution (due by 15 May).

13. The Treasury's tax proposal that finds favour with both Republicans and Democrats, and which is given most emphasis in the tax reform package, is a modified flat tax on income. This is very similar to that proposed by Congressmen Kemp-Kasten (Republicans) and Bradley-Gephardt (Democrats). It would reduce the existing fourteen-rate structure to three rates (15%, 25% and 35%), and eliminate many loopholes. It retains only really essential or politically necessary deductions such as those for mortgage interest on the first home, and severely restricts deductions for charitable contributions and for State and local taxation. Even more controversially, a separate proposal reduces provision for the depreciation of plant and equipment owned by businesses in exchange for a reduction in the rate of corporation tax to 33% (a move, like several elements of the Treasury proposals, towards a system similar to the UK's). There are no more tenacious lobbyists in Washington than those whose field is taxation, and there is an obvious danger that reductions in individual and corporate tax rates will go through, but that the unpopular closure of loopholes will not. What sets out as revenue-neutral may end up rather different. The US Treasury, who greatly admire the Chancellor's 1984 budget, wish they too could move budget resolutions on budget day, and be sure of a Finance Act by the autumn.

14. Not only will lobbyists for groups of individual tax-payers be against loophole-closing, but some supply-siders will oppose as a matter of principle any major reductions in the depreciation

provisions for businesses, and may find an ally in Senator Packwood (the new Chairman of the powerful Senate Finance Committee) who likes the tax system as it is. But having proposals for tax reform on the table may eventually provide the Administration with an opportunity to gain more revenue by raising the nominal rates of tax above those proposed and below present nominal rates, while closing some loopholes. But they are in no mood to seize such an opportunity yet. A more likely outcome would be a complete standoff on tax reform, particularly if the President retains his present aloofness from the Treasury proposals.

15. If the tax reform package could be passed, this would have the effect of tending to reduce US interest rates. The limitation of personal interest relief to mortgages on a first home, the indexation of interest relief, and the lowering of tax rates would reduce the incentive to borrow, easing the demand for credit. The increased tax incentive for saving and the indexation of interest receipts would tend to increase the supply of savings. This would all be beneficial from our point of view.

Procedural Reform

16. There are hardly any signs now that the Administration intend vigorously to pursue a constitutional requirement for a balanced budget as part of their FY 86 budget proposals. This would be irrelevant to deficit reduction in the next

five years because it would take so long to ratify by the States; the proposal for a line-item veto seems also to have dropped out of everyone's but the President's sight. But there is widespread discontent with the 1974 Budget Act and Representative Obey (D-Wisconsin) has recently made a proposal that is receiving considerable attention. Congress at present spends about one-quarter of its time on a budget process which includes a non-binding Budget Resolution that is ineffectual because it is not taken seriously as an expenditure (or taxation) limit. It then has no time to pass the tax and (especially) the appropriations provisions which do have legal effect. The result is that at the end of each fiscal year there is usually an undignified scramble to pass a Continuing Resolution to fund Government programmes during the next year.

17. Obey's proposal is to have the Appropriations and Tax Committees report their recommendations for the following fiscal year to the floor of the House of Representatives by June of each year which, when coordinated by the Budget Committee and approved on the floor, would have immediate legal effect. This would have the merit of forcing Congressmen to vote the tax and expenditure sides of the budget at the same time, and hence to support a specific deficit. The Obey idea is also intended to get the budget out of the way

to free the Congress for other activities. It has some chance of being adopted, but the timetable which it envisages (ie agreement on a comprehensive budget proposal by June of each year) is thought to be extremely tight in terms of the Congressional calendar. Because it would upset the balance of power within the existing House committee structure, this proposal is not likely to be adopted this year.

Conclusion

18. The prospects for early progress towards reducing the US budget deficit look to be poor, and the outlook for tax reform in 1985 is also dim because of the difficulties of closing tax loopholes and Senator Packwood's appointment as Senate Finance Committee Chairman. The Democrats in Congress and the President have taken positions too far apart for early progress to be made on the deficit without a catalyst, for example a major financial crisis such as the collapse of the dollar or a sharp rise in interest rates. The continuation of the American economic recovery does not seem as secure as it looked several months ago and, if growth continues to slacken, corrective action on the deficit will be both more politically difficult and more necessary.

19. We shall need to continue to put on public record our view that the deficit is far too high. But there also seems much to be said for privately advocating a phased programme

of structural deficit reduction, similar to that in our own Medium-Term Financial Strategy. Given the separation of powers, the Administration would of course be unable to control the Congress and so impose continuity. But at least performance could be checked against a plan containing specific targets. Some degree of discipline might result. We might do well to advocate privately to the Administration, and especially to influential Congressmen, the merits of an MTFS. It would be helpful if this could be done in conjunction with our EC partners.

20. The outlook for the deficit is not entirely one of gloom. The American system, while not designed for efficiency, can be expeditious once a political consensus develops on individual issues. Even without an economic or financial emergency, it is quite possible that, say, pressure from the public and the media about the rising tide of public debt, could force some action. If so, a deficit reduction programme could be quickly put in place. But any compromise seems likely to require the President to move considerably from his present position and to accept the need for revenue increases. This will be difficult for him: the Prime Minister's visit to Camp David on 22 December is very important.

TAX REFORM

LOBBYISTS

BY AUTH FOR THE PHILADELPHIA INQUIRER

OFFICIAL TEXT

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VOLCKER OPTIMISTIC ABOUT U.S. GROWTH
(Excerpts: Volcker on the U.S. economy)

Washington -- A slowdown in growth such as the United States experienced during the third quarter of 1984 is typical of recovery periods and there are "reassuring signs for the future," according to Federal Reserve Board Chairman Paul Volcker.

In a speech last week in New York City, Volcker said such slowdowns are typically related to temporary imbalances in inventories, which seems to have been the case in the third quarter. He pointed to "continuing growth in income and employment and relatively strong investment plans" as indications that growth will resume. In addition, "the decided decline in interest rates as the growth rate has slowed should help support both housing and investment, and the related easing of pressures on bank reserve positions by the Federal Reserve will help keep money and credit growing."

Other points made by Volcker:

-- The Federal Reserve has the responsibility to support orderly growth in demand, in line with potential, and "we intend to meet that responsibility." Moreover, "with the dollar so strong internationally, and with inflationary trends more favorable, I believe we have more flexibility in the conduct of policy than for some time, without raising alarms about a new inflationary surge."

-- While the "inflationary dragon" has not yet been slain, "it is fair to suggest that, for the first time in a long while, it's on the defensive." Confidence that inflation will remain low is one of the basic prerequisites for a decline in interest rates.

-- The high level of U.S. imports "has been a crucially important contribution to world economic health at a time of high unemployment and halting recovery in Europe and when many Latin American countries have been struggling to get their own finances and external accounts in order," but running such a large trade deficit is not sustainable indefinitely.

-- For the moment, the United States is "addicted to foreign borrowings" to reconcile its budget deficit and investment needs with its limited propensity to save, and the constructive approach is "to act to end the addiction by moving promptly and effectively to reduce the budget deficit."

Following are excerpts from Volcker's speech:

This decade, economically speaking, started in a discouraging -- even frightening -- way. As a nation, we had come to expect that

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inflation had become a way of life. As we did so, it predictably began to accelerate. People preoccupied with how to beat inflation began to worry more about how to trade their houses for capital gains and about the price of gold than about how to do their jobs a little better. And in that environment, it is not so surprising that productivity growth practically stopped, and so did real increases in income. Once price increases threatened to get out of hand, even the textbook axiom that there was a "trade-off" between a little more inflation and a little less unemployment didn't seem to work. We ended up with more of both....

I'm not going to argue...that we have, as yet, slain the inflationary dragon. But it is fair to suggest that, for the first time in a long while, it's on the defensive. And I think that once we got down to the serious business of controlling inflation, the gains have been greater -- and come faster -- than many thought possible. Measured by consumer prices, inflation has been running at a rate of little more than four percent a year, still far from satisfactory, but lower than in more than a decade. Wholesale prices of goods have been rising very little -- not at all for six months. That is a good omen that, for the time being, prices at the retail level will remain under control.

The first progress toward lower inflation occurred during a deep recession. There was a natural inclination to be skeptical. We had seen that before; it would be only a cyclical phenomena; just wait, inflation would, like arthritis pain, come back with a change in the weather.

In that light, the most encouraging news is that, after two years of strong expansion, the trend has remained better. And as it has, there have been signs that success can help breed further success.

For instance, as expectations of inflation have slowly diminished, labor doesn't have to fight so hard for increasing wage settlements simply to stay ahead of the game. That helps keep costs under control, and in turn reinforces the disinflationary process.

As prospects for greater price stability have improved, the chronic weakness of the dollar internationally during much of the 1970's has been dramatically reversed, indeed to the point of concern that the competitive pressure of imports on some of our most important manufacturing industries may be excessive. Whatever the precise optimum level of the dollar in relation to other currencies, the message is clear that the renewed emphasis on productivity and efficiency born in the adversity of recession must be maintained and reinforced.

And, as confidence gradually strengthens in our ability to restore reasonable price stability -- a confidence that can be earned and kept only by sustained performance -- we will have put in place one of the basic prerequisites for interest rates returning to, and staying at, the much lower levels we have enjoyed historically.

All of this, as you know, has been accompanied over the past two years by the strongest peacetime economic expansion in many years. Both employment -- with 6.5 million new jobs created over the past two years -- and average real incomes have gained. Consumption has been high, but investment has also surged. After-tax profits, relative to GNP, are as high as in some time.

But, of course, all this started from a low level. With unemployment still well above seven percent, we still have a considerable distance to go before we can be satisfied that we are operating at levels close to our true potential. With continued

sizable increases in investment, we should be able to keep our physical capital in line with needs. And more competitive markets will help keep prices under control.

But I would fail to be in character, as a central banker and practitioner of what has been called the dismal science, if I did not emphasize to you that, despite all these recent gains, all is not right in the economic state of the United States. We face some tough policy choices -- tough politically and tough economically. Unless they are resolved soon, and resolved satisfactorily, all those bright prospects will be in jeopardy.

The current economic news has been full of reports of a sharp slowing in the rate of economic growth during the summer and early fall. In one sense, that is not surprising; the pause comes hard upon an exceptionally sharp rate of increase in the GNP, at a rate of some 8.5 percent, during the first half of the year. The barrage of attention, in this media age, to every twist and turn in the economy should not obscure the simple fact that it's not in the nature of the economic beast to move forward, quarter by quarter, with military precision.

A sharp slowing in growth for a time during an expansion period is in fact historically common, typically related to temporary imbalances in inventories following a period of rapid accumulation and temporary fluctuations in consumption. Something of that sort seems to be at work this fall.

Continuing growth in income and employment and relatively strong investment plans are reassuring signs for the future. The decided decline in interest rates as the growth rate has slowed should help support both housing and investment, and the related easing of pressures on bank reserve positions by the Federal Reserve will keep money and credit growing.

But the question persists -- is that all there is to it? Is something more fundamental at work that could lead to more serious difficulties?

We don't have to look far for a possible culprit. Fed mainly by an enormous increase in imports, our international trade deficit reached a new high of about 130,000 million dollars at an annual rate during the summer.

Throughout the expansion period, the trade balance has been deteriorating, and so has, in parallel, our overall external current account, which measures imports and exports of all goods and services. Since late 1982, the current account deficit has increased by almost 100,000 million dollars to an annual rate in the neighborhood of 120,000 million dollars during the third quarter.

When we import more goods and services than we export, we must pay for it in the only way we can -- by borrowing capital from abroad in the same amount. For the time being, that has not been difficult. Relatively high interest rates, growing confidence in our economic prospects, and political stability have all acted as a magnet for foreign funds. But I must also point out that the United States is importing capital so fast that the largest and richest country in the world is well on its way to becoming the largest international debtor as well.

The growing trade deficit, and the related capital inflow, have some highly significant implications. For one thing, we as a country have been consuming significantly more than we have been producing. The GNP -- a measure of production -- has risen by about twelve percent in real terms over the past two years. Domestic spending has

ri[illegible] appreciably faster, by more than 15 percent. In essence, a lot of demand generated in this country has flowed abroad, generating production and income in other countries. We didn't feel it much, in overall terms, while our own production was expanding so rapidly. But it made a very noticeable impact last quarter, when domestic demand continued to expand at the relatively rapid rate of more than 5.5 percent, while GNP growth slipped to a rate of only about two percent.

Both industrialized and developing countries abroad have benefited from our growing markets. That has been a crucially important contribution to world economic health at a time of high unemployment and halting recovery in Europe and when many Latin American countries have been struggling to get their own finances and external accounts in order. From our own standpoint, the ample supply of foreign goods in our markets has certainly benefited the consumer and helped to keep inflation under control. What may be less understood is that the massive capital inflow has, directly or indirectly, helped enormously in maintaining a reasonable balance in our capital markets during a period of record Federal budget deficits.

The simple fact is demands on our savings -- from business investment, from housing, and from the Federal deficits -- currently exceed what American individuals, businesses, and state and local government pension funds are willing to save by an amount equivalent to about three percent of the GNP. That shortfall is, in effect, being covered by drawing on the savings of other countries; the net financial inflow in the third quarter appeared to be running at a rate of some 120,000 million dollars a year.

Let me put the point another way. I am sure many people, worried about the budget deficit a year or more ago, feared that deficits would "crowd out," as the phrase goes, domestic housing and investment as economic recovery took hold. There was understandable concern that interest rates would be under very strong pressure -- that there wouldn't be enough money to finance both rising investment needs and a Federal deficit in the range of 175,000-200,000 million dollars the same time. "Something" would have to give.

Well, yes and no. That analysis, focused primarily on the U.S. potential to save, failed to take account of the sharp increase in the inflow of capital from abroad. Interest rates have indeed been high, relative to most other industrialized countries, and foreign capital has freely flowed into our markets in amounts adequate to enable us to maintain rapid growth in business investment and reasonable levels of housing. That capital inflow was, at the same time, necessarily accompanied by a growing trade deficit. That deficit reflects lost markets for our exporters or manufacturers competing with imports. Those internationally oriented businesses have been the ones "crowded out" -- but that process was not recognized so clearly simply because those industries are widely dispersed, because the chain of causation is indirect, and because the economy has been expanding so rapidly. And, of course, we will have to pay interest on those foreign borrowings for many years.

Given all the apparent advantages -- the stimulus to world growth and adjustment, lower interest rates domestically than would otherwise have been possible, and the benefits to consumers of relatively low priced foreign goods -- why it might be asked, should we be so concerned?

For a simple reason. Strong as the United States is, and encouraging as is our progress toward price stability and greater

productivity, borrowing so much abroad, and running so large a trade deficit, is not sustainable indefinitely.

For one thing, there is a political as well as economic dimension. So large a deficit understandably intensifies, among affected industries, the already strong pressures for protection. A lot rides on the ability of the administration and the Congress to contain those pressures, for yielding here will certainly be matched, and more, by retaliation abroad. I can think of no scenario more conducive to undermining world economic growth, and more particularly the prospects for the poor countries already struggling with debt problems. And at the same time, it would provide as strong inflationary impetus.

Economically, protectionist measures are a diversion from the underlying problem. Suppose we somehow succeeded, in short order, in sharply reducing the trade deficit and its counterpart, our borrowing from abroad? Then, how would we finance our Federal deficit? What would be the implications for interest rates -- and thus for housing and investment?

The hard reality is that, for the moment, we are addicted to foreign borrowings to reconcile our deficit and our investment needs with our limited propensity to save at home. Yet, we can't count indefinitely on the capital inflow -- among other things, growth needed in other countries requires that they employ more of their savings at home. At some point, as our debts rise, confidence could be undermined. Surely, the constructive approach is to act to end the addiction by moving promptly and effectively to reduce the budget deficit, restoring better balance to our domestic capital markets, encouraging lower interest rates, and reducing the pressures on internationally oriented business....

My thesis...is a simple one. We have come a long way toward restoring the prospects for price stability and for sustained growth. The benefits have flowed throughout the world, not just to the United States. But we have already delayed too long in facing up to a fundamental imbalance -- reflected in those related budgetary and trade deficits -- that left untended, poses a great threat for the future.

The current pause in economic growth need be no more than that. But it should be warning enough that this is no time to bask idly in the warmth of past progress, at the plain risk that, instead of controlling our own economic destiny, we fall prey to crisis and dislocations.

There are responsibilities aplenty for others: for business and labor to continue working together to improve efficiency, to contain costs, and to innovate; for other nations, in Europe and elsewhere, to stimulate their own growth so that so much of the responsibility for maintaining a healthy world economy does not fall on the United states alone; for heavily indebted countries to build upon the progress they have made to get their own finances more completely in order. And there are encouraging signs in all those areas.

But there is simply no escape for appropriate action by the United States as well -- too much rests upon our ability to conduct prudent and disciplined monetary and fiscal policies.

The record of the past two years seems to me to provide dramatic evidence of the benefits that flow from facing up to the problems that once seemed almost insurmountable. With the same exercise of will and foresight, we will be able to look back upon the current pause as simply part of the transition to more stable and sustained growth.

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DEBT PROBLEM MANAGEABLE, VOLCKER SAYS

(Excerpts: Volcker speech on the debt situation)

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Washington -- The international debt problem is manageable, and with effort should remain so, according to Federal Reserve Board Chairman Paul Volcker.

Speaking to the American Swiss Association in New York November 29, Volcker said success will depend on sustained growth by industrialized countries, avoidance of excessive real interest rates and maintenance of open competitive markets, both in the industrialized and developing worlds.

Other points made by Volcker:

-- Federal Reserve analysis supports the conclusion of others that "trend growth by the industrializing developing countries of five percent or more annually can be restored in the years ahead consistent with significantly falling debt burdens," while at the same time the banks with loans to these countries can reduce their exposure relative to their capital.

-- Hard analysis does not support the pessimistic earlier view of some that substantial increases in official aid or across-the-board writedowns of debt by the banks would be needed to avoid financial breakdown.

-- The most important contribution the industrial world can make to further improvement in the debt situation is "to maintain orderly economic expansion, with the important by-product of a favorable external economic environment for developing countries seeking to expand exports."

-- All industrialized countries have to resist protectionist pressures, but this is not a matter to be addressed by them alone. "Protectionism...can be as much or more of a handicap to growth and development when practiced by the developing countries themselves."

-- "A thicker layer of equity risk capital (in debtor countries) would be the best possible base for encouraging a restoration of normal bank lending." The return of confidence in these countries implied by a surge in private investment, both domestic and foreign, would provide the strongest possible evidence that debt problems are over.

Following are excerpts from Volcker's speech:

(begin excerpts)

It's a particular honor and delight for me to receive your award today. Central bankers, even more than others, are bound to admire and respect the success of the Swiss both in maintaining so large a

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measure of monetary and economic stability internally over the years and in contributing so importantly to world financial affairs. What a demonstration of the tangible benefits of financial discipline and common sense Switzerland is.

I am tempted to hypothesize that Swiss success reflects the fact that Switzerland maintains a strong and independent central bank.

Now, I'm not about to reject that thought entirely. But I am ready to acknowledge that something even deeper may be at work as well -- a matter of national character and experience and enlightened self-interest of those living in what is, after all, a small country poorly endowed with natural resources.

The career of my good friend Fritz Leutwiler, who will soon be retiring from his responsibilities at both the Swiss National Bank and the Bank for International Settlements, has been squarely in the Swiss financial traditions, and he has brilliantly added to it. All of us in other countries who have worked closely with him during these turbulent recent years are bound to sorely miss his practical leadership and wise counsel. In no area will that be more true than in dealing with the continuing problems of international debt.

Fritz brought to the days of crisis from the earliest tremors in Eastern Europe an understanding, a willingness to act and to lead, and a personal influence that were indispensable to managing the situation. That job is still far from complete -- by its nature it will be the work of years. But I also think it is fair to say that today, for all the obstacles still ahead, we can see that the earlier sense of hopelessness expressed by some is plainly not justified, that the main avenues to success can be more clearly identified and more broadly understood, and that strong cooperative efforts by borrowers and lenders alike can be elicited, in their mutual interest, to help manage the situation.

Before substantiating those points, a sense of the origins and nature of the problem seems to me essential. It's often explained in terms of specific events -- the successive oil crises, the impact of historically high interest rates in the early 1980's coinciding in part with a prolonged recession, and errors by lenders or in economic management by particular borrowers. Obviously, those particular events and circumstances were significant. But there have been broader forces and attitudes at work.

The international debt problem -- important as it is quantitatively and in terms of its impact on so many countries, so many people, and so many financial institutions -- is only one symptom of a larger challenge: a transition from a highly inflationary environment to restoration of the financial underpinning of sustained, non-inflationary growth.

Bank lending to a whole tier of important developing countries -- those moving rapidly toward industrialization -- got its initial strong impetus in the early 1970's when the first oil crisis greatly added to financing needs at a time when strong growth patterns and rising commodity prices had greatly improved confidence in the basic outlook of the borrowing countries. The ability of the banking system to respond flexibly and vigorously to those needs itself reinforced confidence. But the expotential further rise in bank lending through the 1970's, and the second 1979-80 oil crisis, can only be fully explained, in my judgment, in the context of other, more fundamental, developments and attitudes. There was a common perception of continuing and even accelerating inflation and exceptionally low real interest rates, a sense that government would nonetheless be able and willing to maintain relatively strong growth in the world as a whole,

and an implicit assumption that the kind of financial crises experienced by our fathers and grandfathers were more a relic of history than a future threat.

So long as new loans flowed freely, rapid growth could be maintained in many developing countries, and inflation seemed to wash away much of the increased debt burden. It was also true that both interest payments and debt maturities were, in effect, being made only with the proceeds of new loans. That is not, in itself, an unusual or necessarily disturbing circumstance -- it is, in fact, a normal part of the growth cycle for a company or country. But it is sustainable only when the debt is maintained, and seen to be maintained, in some manageable relationship to real growth and productivity, with a liquidity or borrowing cushion against inevitable periods of recession and disturbance.

Looking back, it's much easier now than in the 1970's to see the warning signs that the process was not in fact sustainable for some countries, and that it had become dependent on accelerating inflation and exceptionally low real interest rates. Lending banks had permitted their own capital ratios and liquidity to erode, increasing their own potential vulnerability. And, perhaps most ominously, late in the 1970's and at the start of the 1980's accelerating capital flight from a number of borrowing countries signaled deteriorating prospects for productive investment; at the same time, larger amounts of external, public borrowing were required to finance the outflow.

The implicit assumption of rising inflation, low real interest rates, and sustained world growth were abruptly undermined in the early 1980's. When the crisis erupted in Mexico, reflecting a particular combination of political and economic circumstances, the simple fact is much of the continent of South America, as well as some other important borrowers, had become vulnerable to even a temporary change in circumstances and market psychology. One clear danger was that self-protective instincts of individual lenders to cut risks and exposures by suddenly curtailing new loans would not only grievously impair the stability of their borrowing customers but also pose large risks for all creditors with large loan exposures -- a category including most of the major international banks.

Happily, there was not only prompt recognition on all sides of that danger to the international financial system but a strong willingness to participate in a collective approach to deal with it. I will not review the details of that cooperative effort. Suffice it to say it had several critical ingredients.

The efforts of the borrowing countries themselves to reduce external needs -- an effort that initially inevitably required emphasis on curtailing swollen imports -- and to become more competitive and productive over time were absolutely critical. But those efforts would have been fruitless without recognition by banks of their own interest in orderly refinancing of old loans and the provision of enough new money to maintain the viability of the adjustment programs undertaken by borrowers. The role of the International Monetary Fund (IMF) in the process has, of course, been essential. It could, as it was designed to do, provide a critical margin of new money. I sense more important, if less measurable, has been its ability -- as an internationally respected, competent, and neutral financial (and intellectual) intermediary -- to seize the initiative in coordinating the effort, country by country, and to maintain surveillance over the entire process.

The founders of the IMF could hardly have foreseen this role, and few of us, even a few years ago, could have appreciated the importance it would assume. Of course, it has had to be supported, with

resources and otherwise, by governments and central banks of the leading countries....

Now, more than two years after Mexico had to declare a temporary standstill on its debt repayments, we can take some satisfaction from the fact that the crisis facing major developing countries and the system has been contained and kept manageable. For some of the most important borrowers -- notably Mexico, Venezuela and Brazil -- more can be claimed. They have made unexpectedly rapid progress in external adjustment, and have succeeded in rebuilding significant financial reserves. Two of them have negotiated long-term debt restructurings on terms that they should realistically be able to meet, and the third has plans to do so.

It's equally obvious that points of vulnerability remain, and to some extent, problems can remain contagious. Argentina, for instance, only now is at a critical point in negotiating with its creditors for a sizable amount of needed new money and debt rollovers, following prolonged consultations by the new and democratic government on an appropriate adjustment program with the IMF. Other smaller Latin American countries, as well as a few elsewhere, remain in a very difficult position, economically and financially.

Under the circumstances, it's still too soon to close the book on what might be thought of as "stage one" of handling the LDC (less developed country) debt problem -- urgent crisis management. But it's not too soon to begin work on stage two -- the transition to renewed growth and stability. I suggested at the start that the broad prerequisites for success can be identified, and at a general level command a broadening degree of agreement as consistent with realistic and reasonable assumptions.

In essence, econometric and other analysis at the IMF and World Bank, as well as among some private analysts, suggest trend growth by the industrializing developing countries of five percent or more annually can be restored in the years ahead consistent with significantly falling debt burdens and much reduced exposure relative to capital or lenders. Our own work in the Federal Reserve supports these conclusions.

The assumptions typically made in these studies do not strike me as heroic: growth averaging about three percent a year among the industrialized countries, well within historical experience; real dollar interest rates within the range of those experienced over the past year or so (an assumption which could well be unduly pessimistic); and no large change, up or down, in oil prices. Projections for individual countries made by both borrowers and lenders in developing longer-terms restructuring programs, such as for Mexico, lend credence to the more general analysis.

I am well aware that econometric projections are not the same as reality; the real world has more surprises, and more fluctuations, than can ever be captured in a series of equations averaging past relationships. But I believe the work does demonstrate effectively that all the effort on crisis management has not led us into a blind alley, only postponing an inevitable day of reckoning. Hard analysis simply does not support the pessimistic earlier view of some that such extreme and unlikely measures as substantial new official aid programs or across-the-board writedowns of debt would inexorably become necessary to avoid financial breakdown.

But, conversely, there should be no presumption that favorable results are assured and automatic. All those who have cooperated in crisis management will have important continuing roles to play. That sounds as though the patience of all could be sorely tested -- except that the actions needed are basically consistent with the individual interests of the several parties, debt problems or no.

For example, the most important need for the industrialized world to maintain orderly economic expansion, with the important by-product of a favorable external economic environment for developing countries seeking to expand exports. For the past 18 months, the United States has played a particularly large role in supporting world growth. Our huge and growing trade deficit and the much slower rate of U.S. growth for some months -- while not in itself exceptional during an expansion period -- should also be reminders enough that the responsibility for encouraging growth should not fall on one country alone. Indeed, looking ahead, the historically high levels of unemployment that have persisted in Europe for some time, and the progress that has been made against inflation, suggest the potential for above-average growth rates in that key industrial center for a while.

To me, it is obvious as well that prospects for balanced growth with more moderate interest rates in this country would be greatly enhanced by a strong and early attack on our now chronically large budget deficit. Given our weight in the world economy, that deficit not only overstrains our capacity to save domestically, it absorbs too much of the limited supply of capital abroad.

All the industrialized countries will have to work hard and in concert to resist protectionist pressures. There is no doubt that rapid increases in imports from the developing world pose difficult adjustment problems for long-established industries here and elsewhere; temptations to curtail imports become well nigh irresistible when markets in other countries are closed. But there is also no doubt that the ability of the developing world to grow and service its debt is dependent on rising exports -- and that their development will also stimulate a comparable flow of exports from the industrialized world. In the end, the productivity and standard of living of all countries is at stake.

The question should not be addressed to industrialized countries alone. Protectionism, or what amounts to the same thing -- a network of subsidies, controls, and artificial pricing -- can be as much or more of a handicap to growth and development when practiced by the developing countries themselves. Far too often, a few favored industries are supported and pampered at great cost, budgetary or otherwise, sacrificing the competition that spurs efficiency and harming other sectors -- often including agriculture -- operating far below their potential.

That lost "potential" may have appeared less urgent when bank loans from abroad seemed abundantly available on easy terms. But the only prudent assumption today is that those days of lenders aggressively "selling" loans to the most heavily indebted are gone, certainly for years ahead. Realistically, given the scars of recent experience, the relative exposure of a number of large banks to particular countries is likely to remain larger than they would desire for some time. Many smaller banks, attracted to foreign business beyond their normal market areas, may wish to retrench. I do not suggest that when conditions justify -- including satisfactory performance with respect to IMF-sponsored adjustment programs -- long-term restructuring of existing debts at reasonable spreads should not be expected in more countries, or that cooperative efforts to raise essential amounts of new money will not be successful. In appropriate circumstances, the common interest in those efforts remains compelling. But truly spontaneous lending by individual institutions to countries with serious debt servicing difficulties may be confined largely to trade credits for a time, and even as confidence more fully returns, new lending is likely to remain moderate by the standards of the 1970's for years to come.

There can be, in fact, no common interest in simply resuming the lending patterns of earlier years -- lending that would ultimately again threaten the stability of lenders and borrowers alike. Banking and supervisory agencies here and elsewhere will themselves want to guard against that eventuality.

All of that emphasizes the need to make more effective use of savings generated internally as well as externally -- the former in any event will always be the most important source of capital for any country. That is a difficult and politically sensitive area in which every country will have to find its own solutions, suited to its own traditions and philosophies. But having said that, I cannot refrain from making several observations on the current scene.

A number of heavily indebted countries have made the strongest kind of effort, under crisis conditions, to make fundamental adjustments in their economies, often at the expense initially of cutting already low standards of living and aggravating structural problems of unemployment. The results in their external accounts have been remarkable. Internally, progress has typically been more difficult. Inflation in a number of countries is still rising, or falling more slowly than anticipated. For a variety of reasons, business and agriculture have been delayed in reorganizing and enhancing efficiency, and many incentives seem to remain perverse.

As the immediate crisis recedes, there will be strong and legitimate demands for renewed growth and employment. That will need to be done without counting on such large injections of new bank lending as in the past or much more rapid expansion of officials lending from abroad to make up for an inability to generate usable domestic savings.

I would like to be able to say with confidence that many foreign companies or other potential foreign investors are poised today to support those needs by means of large new equity investments -- either as active managers, as partners in local enterprises, or as portfolio investors. Potentially, I believe such investors do exist, and in large numbers, given the local opportunities for profit in expanding domestic markets and international markets. But, with a few significant exceptions, potential investors are hesitant and reluctant. Many seem less concerned with creditworthiness than with -- as they see it -- a history of distrust about private and foreign business, a perceived absence of security for private capital, and excessive controls.

One does not have to look to foreign capital to make the point. In country after country, debt problems were greatly aggravated by massive capital exports by their own citizens -- capital that once exported is likely to provide little or no earning for use of the country as a whole. When a nation is unable to attract and efficiently employ the capital of its own citizens, prospects for attracting the equity participation of others is slim. Yet, that is precisely the kind of fund -- whether in the hands of their own entrepreneurs or from businesses abroad -- that could spark and sustain the growth and the productivity that is so sorely needed. And, not so incidentally, in financial terms, a thicker layer of equity risk capital would be the best possible base for encouraging a restoration of normal bank lending.

These are not theoretical propositions -- there are obvious examples around the world of developing countries with an hospitable climate for investment that have managed to maintain their growth and attract foreign capital in the midst of the debt crisis affecting so many other countries. I realize that habits and attitudes built up over many years, whether by foreign investors or within a country, are

hard to change, and the prevailing cautious attitudes of foreign investors may no longer be fully justified by objective facts in some countries. But one senses that, with attention, greater opportunities can be developed in the mutual interest. Certainly, the return of confidence implied by a surge in private investment, domestic and foreign, would provide the strongest possible evidence that the debt problems are indeed behind us, and that hard-pressed borrowing countries can confidently again look forward to sustained growth and raising standards of living.

Let me summarize my thesis in a few sentences. The debt problem is, and with effort should remain, manageable. While the particular conditions and circumstances differ widely among them, a number of developing countries, working with the IMF, have made striking progress toward achieving external balance without heavy dependence on new bank lending. In that context cooperative efforts by lending banks -- again typically in the context of IMF programs -- will remain justified and essential for some time to achieve realistic repayment scheduled for existing loans and to raise amount of new funds essential to finance adjustment.

As we look ahead, these efforts should be consistent with renewed strong growth by the borrowers, and with significantly reduced debt servicing burdens of borrowers and reduced exposure by lending banks (relative to their capital or assets). Indeed, ultimate success, from the viewpoints of borrowers, lenders and the world at large, is dependent upon reaching those results. Reasoned analysis strongly suggests those results can and will be reached, provided growth by industrialized countries is sustained, excessive real interest rates are avoided, and open competitive markets are maintained, both in the industrialized and developing worlds.

Viewed in that light, the basic policy requirements for success in resolving the problems of international indebtedness are the same as those for meeting our economic problems more generally.

So far as the United States is concerned, the message seems to me very clear. All the arguments for maintaining progress toward price stability, for dealing with the budget deficit, for resisting protectionism, for encouraging productivity, are reinforced and made more urgent.

I am sure there are pointed lessons for others as well. If we succeed even moderately well in acting upon those lessons -- and that is certainly well within our several capacities -- I see no reason why this debt crisis, as so many crises before, cannot in the end be turned to constructive opportunity.

US ECONOMY

ESSENTIAL FACTS

US output growth slowed to an unexpectedly low 2 per cent (annual rate) in the third quarter following growth of 10 and 7 per cent in the first and second quarters respectively. Flat consumption together with a large rise in imports account for most of the slowdown - stockbuilding rose sharply. In October industrial production barely changed but both orders and other leading indicators continued to fall again.

2. Debate continues as to whether the recent slowdown is a 'pause' in growth or marks the start of a recession. In a recent speech Volcker was optimistic and argued that the slowdown partly reflected stock imbalances and pointed to some encouraging signs such as the continuing rise in employment and bullish investment plans. Most forecasters see the US economy growing by 3-3½ per cent next year though the Administration has yet to revise its own assumption of 4 per cent growth. Prospects thereafter are less clear.

3. Unemployment fell in November to 7¼ per cent compared to the last peak of almost 11 per cent at the end of 1982. Over the same period civilian employment has risen by over 6 million.

4. Inflation remains modest at 4¼ per cent with settlements still low. Consumer price inflation could rise a little next year but any sharp fall in the dollar could worsen prospects considerably.

5. US interest rates have fallen by over 2½ points since the summer but seem to have firmed more recently. Short rates now stand at 9 per cent with long rates at 11½ per cent - slightly lower than at the start of the year with inflation broadly the same.

6. The dollar rose to a new peak in mid October. Since then it has eased but more recently it has been rising again. The trade deficit declined slightly to $9bn in October making a

cumulative total this year of $106bn. Most expect a trade (current account) deficit of $130bn ($100bn) this year as a whole and some further increase next.

7. In September the Federal Open Market Committee decided to ease its monetary stance because of the slow growth in some of the monetary aggregates, weakness in the economy and lack of any clear inflationary pressures. Discount rate was cut by ½ point to 8½ per cent in November as the Fed became increasingly concerned over the slowdown in growth. After negligible growth in recent months M1 has risen sharply in the last few weeks to stand in the middle of its target range. Last summer Volcker announced the Fed's provisional monetary targets for 1985 when he lowered the M1 and M2 targets slightly. He will confirm or change them in February.

Aggregate	1984 Target	Latest	1985 Target (prov)
M1	4-8	6 (mid Nov)	4-7
M2	6-9	7 (Oct)	6-8½
M3	6-9	9¾ (Oct)	6-9

8. The Administration now estimates the US Federal deficit as $205/210bn in fiscal 1985 which, on our own forecasts of 3½ per cent growth next year, is equivalent to almost 5½ per cent of GNP. Without further cuts outstanding government debt could virtually double between 1983 and 1989 rising from under 35 to almost 50 per cent of GDP. Interest payments could reach over 20 per cent of revenues in five years time.

9. Many argue that the fiscal deficit position is ultimately unsustainable. Some also hold that the scale of expenditure cuts likely to be agreed is inadequate and see tax increases as necessary to reduce the deficit to sustainable levels.

10. President Reagan is considering an expenditure freeze for fiscal 1986 and a range of expenditure cuts in non-defence, non-social security areas with the objective of lowering the deficit to $100bn or 2 per cent of GDP by 1988. Reports suggest he has agreed to selective cuts of $34bn for fiscal 1986 and further reductions in later years but these do not touch social security. As yet no reductions in defence plans have been finalised. Full details will not be known until the President announces the budget towards the end of January next year.

11. The US Treasury's tax reform is presented as revenue-neutral though it shifts the burden away from consumption and towards the corporate sector. Tax increases are not being considered but without extra revenue there is no real possibility of the deficit being reduced to sustainable levels.

Foreign and Commonwealth Office

London SW1A 2AH

4 December, 1984

Dear Charles,

Visit of Mr Volcker

Thank you for your letter of 27 November and for that from David Peretz of the same date. Mr Volcker has confirmed that he will call on the Prime Minister at 7.15 pm on Thursday, 13 December at the House of Commons, and on the Chancellor at 4 pm on Wednesday, 12 December at No 11.

I am copying this letter to David Peretz (HM Treasury).

Yours ever,

Colin Budd

(C R Budd)
Private Secretary

C D Powell Esq
10 Downing Street

Note

HMT will send briefing on Wednesday. In addition I agreed we would confirm Wednesday evening to check on outcome of Chancellor's meeting.

10/12

PM: Mtg with Volcker Jan 85

-4 DEC 1984

B/F with Volcker meeting folder

CONFIDENTIAL

(2) You could raise X with Mr Volcker when you see him in December. AT 27/11

PRIME MINISTER

THE DEBT PROBLEM

I should have told you that I am chairing a meeting on the International Debt Problem on Friday, 30 December.

The members of the group include Fritz Leutweiler, Roberto Campos (ex-Minister of Finance, Brazil), Calos Carceres (ex-Minister of Finance and Economy, Chile), Karl Brunner, Jan Tumlin (Director of Research at GATT), Goh Keng Swee (ex-Minister of Finance, Singapore).

The group is sponsored by the Global Economic Research Institute which is presided over by Robert Anderson (ex-Secretary for Treasury, USA).

The object is to get an informed but independent view of the solutions which have been proposed and to suggest an alternative solution.

You might like to see the attached article which demonstrates that the "100% face value" fiction is gradually cracking. All that is required to bring the edifice down is one modestly large failure (Peru, Bolivia?).

X I very much regret that we did not manage to persuade the Fed and the Bank, together with other central banks, to get an orderly disposal market-process going. Now all we can do is contingency planning.

ALAN WALTERS
27 November 1984

CONFIDENTIAL

7.14

US file

AT

CDJ 28/xi

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

27 November 1984

P F Ricketts Esq
Foreign and Commonwealth Office
Downing Street
LONDON SW1

Dear Peter

VISIT OF MR VOLCKER

The Chancellor has seen telegram number 3503 from Washington. He would welcome an opportunity to meet with Mr Volcker at No 11 Downing Street between 11 and 15 December. I should be grateful if arrangements could be made with our Diary Secretary, David Baillie, for him to call.

I am copying this letter to Charles Powell (No 10).

Yours ever
David

D L C PERETZ
Principal Private Secretary

10 DOWNING STREET

From the Private Secretary 27 November 1984

Visit of Mr. Volcker

The Prime Minister sees from Washington telegram number 3503 that Mr. Volcker will be in London between 11 and 15 December. She would like to see him if possible. I should be grateful if arrangements could be made for him to call.

I am copying this letter to David Peretz (HM Treasury).

(C.D. POWELL)

P.F. Ricketts, Esq.,
Foreign and Commonwealth Office.

Prime Minister
Do you wish
to see Volcker? * As soon
CDP 25/xi

Yes no

ADVANCE COPY

WQBSADXDG SCV

WONFO 021/24

OO F C O

GR 220

RESTRICTED
FM WASHINGTON 240335Z NOV 84
TO IMMEDIATE F C O
TELEGRAM NUMBER 3503 OF 23 NOVEMBER
INFO IMMEDIATE C G NEW YORK, B I S NEW YORK.

IMMEDIATE

YOUR TELNO 1987: NEW YORK COUNCIL ON FOREIGN RELATIONS (C.F.R.)

1. VOLCKER (WITH HIS WIFE) WILL ARRIVE IN LONDON ON 11 DECEMBER AND PLANS TO DEPART ON 15 DECEMBER. APART FROM A CALL ON THE GOVERNOR OF THE BANK OF ENGLAND, HE HAS ONLY TWO DEFINITE ENGAGEMENTS SO FAR: A SPEECH TO THE CONSERVATIVE BACK-BENCH FINANCE COMMITTEE P.M. ON 11 DECEMBER, AND THE C.F.R. ON 12 DECEMBER.

2. I SHOULD NOT HAVE THOUGHT IT ESSENTIAL FOR MR RIFKIND OR ANY OTHER F.C.O. OR TREASURY MINISTER, TO ATTEND THE C.F.R. LUNCH: EQUALLY, IF THEY WISH TO DO SO, THERE COULD BE NO POSSIBLE OBJECTION. VOLCKER WILL SPEAK INFORMALLY FOR 15-20 MINUTES, AND IT IS NOT INTENDED TO BE A MAJOR SPEECH. IT WOULD BE HELPFUL IF THE EVENTUAL REPLY TO THE C.F.R.'S INVITATION COULD BE TELEGRAPHED TO B.I.S. NEW YORK FOR ONWARD TRANSMISSION TO THE COUNCIL.

3. THE REMAINDER OF VOLCKER'S PROGRAMME IS LIKELY TO BE DRAWN UP DURING THE COURSE OF NEXT WEEK. I IMAGINE THAT THAT THE CHANCELLOR (AND CONCEIVABLY THE PRIME MINISTER) MIGHT WISH TO SEE HIM. IF SO WE SHOULD BE DELIGHTED TO SUGGEST SUITABLE TIMES TO HIS OFFICE.

4. AS YOU KNOW, A NUMBER OF KEY ECONOMIC PLAYERS IN THE U.S. ADMINISTRATION WILL BE PRESENT IN LONDON ON 11 DECEMBER. IT WOULD BE AN OPPORTUNITY LOST IF THEY WERE NOT CORRALLED BY MINISTERS, GIVEN THE IMPORTANCE OF OUR INTERESTS AND THE STATE OF POLICY-MAKING FOR THE SECOND REAGAN TERM WHICH FORMALLY STARTS ON 20 JANUARY AND WILL BE LAUNCHED WITH THE STATE OF THE UNION MESSAGE LATER THAT MONTH. IF, AS SUGGESTED IN TELECONS KERR/MARSHALL, A LUNCH WOULD BE ARRANGED ON 11 DECEMBER FOR SHULTZ, BLOCK AND BALDRIGE - ALL OF WHOM PLAN TO BE IN LONDON THAT DAY - VOLCKER TOO WOULD BE AN OBVIOUS CANDIDATE FOR INCLUSION. I THINK I COULD PROMISE INTERESTING CONVERSATION.

5. F.C.O. PLEASE PASS TO P.P.S./CHANCELLOR, P.S./MR RIFKIND, * TURNBULL (NO. 10), SHIELDS (H.M.T.), MARSHALL (N.A.D.) AND GREEN (BANK). HD News D, HD ERD, Mr Derek Thomas, Mr Braithwaite, Mr David Thomas, RC

WRIGHT

XII

1) Mr. Scholar ✓
2) Prime Minister.

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR

AND THE CHAIRMAN OF THE FEDERAL RESERVE,

AT 10am ON 28 JUNE in NO 11

Mr Volcker agreed that the position on the US deficit was very worrying. He saw no chance that the Administration would voluntarily take effective action. The President probably did not accept the estimates of future deficits of some $200B a year, and certainly attached a higher priority to increasing defence expenditure and reducing taxes than to eliminating the risk of deficits on that scale. Congress was more concerned, but disliked tax increases even more than increased deficits. Interest rates were however likely to rise, and fairly soon, and this might conceivably cause Congress to recognise how damaging the current and prospective deficits were. But of course it would be the Fed which would take most of the blame, when interest rates rose.

2. The Chancellor asked whether interest rates would rise sharply; what exchange rate movements were expected; and to what extent the dollar was taken into account in assessing monetary conditions. Mr Volcker said that the exchange rate was not taken into account in a regular or systematic manner, though from time to time it was necessary to agonise about it. If the dollar had been weaker in the last six months, domestic policy would undoubtedly have been tighter. The dollar certainly ought to weaken soon - but he had been saying that for six months. The fall could be quite sharp, when market sentiment changed, and there were perhaps indications that it was already changing, for the dollar had not strengthened in recent days, though interest rates had edged up. Monetary growth was now rather rapid, and the economy was expanding faster than had been expected. The tax cut due on 1 July was 'absolutely

not required'. On domestic policy grounds there was no doubt that interest rates should rise, and perhaps quite sharply, if only for a short period. But the external and international arguments went the other way. Debtor countries badly needed lower world interest rates.

3. Mr Volcker then said that he had been asked by the Argentine Central Bank Governor to make it plain in London that in the Argentine view a gesture from the UK over the exclusion zone was required before Argentina could lift the remaining restrictions on UK non-banking firms operating there. The Chancellor took note, pointing out that all discriminatory restrictions would have to be lifted before Argentina's July IMF drawing could go ahead.

4. Mr Volcker warned that the situation over the US legislation on the IMF quota increase was far from satisfactory. The Bill which had emerged from the Senate caused no problems; but new amendments being tabled to the House version were highly unsatisfactory. It was not clear either that the Bill would go through - certainly strong Administration pressure would be required - or that it would emerge without damaging amendments attached. The Bretton Woods Act prevented government lending to the IMF in any form without Congressional approval. It was important to keep the issue of IMF market borrowing under wraps until the quota increase was through Congress, for Congress might see market borrowing as an alternative to the quota increase, and block the latter.

5. The Chancellor asked about the exposure of US banks in developing countries now experiencing financial difficulties; and about the possible need for improved surveillance and supervision arrangements by central banks world-wide. Mr Volcker thought that the position of the US banking sector was less volatile than it had been in mid-82. But he warmly agreed that progress on improved, and coordinated, surveillance had been halting and unsatisfactory.

CONFIDENTIAL

The Ambrosiano case was a graphic illustration of a problem not yet solved. It was of course difficult to argue at the same time that the banks must give greater weight to prudential considerations and that they should maintain current lending levels to countries in difficulty. But both points were in fact essential.

6. The meeting ended at 10.50 am.

J O KERR
28 June 1983

Distribution

PS/CST
PS/FST
PS/EST
PS/MST
Mr Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Unwin
Mr Lavelle
Mr Carey
Mr Battishill
Mr Ridley
Mr Bottrill
Mr Peretz
Mr Lankester

Mr Coles, No.10
PS/Secretary of State, FCO
PS/Governor, Bank of England
Sir Oliver Wright, Washington
Mr Wicks, UKDEL IMF/IBRD, Washington

SUBJECT

CONFIDENTIAL

file + to PM
cc Mr Walters
cmaster

10 DOWNING STREET

From the Private Secretary

14 April 1983

CALL UPON THE PRIME MINISTER BY MR. PAUL VOLCKER

Mr. Paul Volcker called upon the Prime Minister this afternoon. Mr. Newman from the US Embassy was also present.

The Prime Minister referred to the half per cent reduction in base rates in the UK this afternoon. Mr. Volcker said that he, too, had been under pressure to reduce interest rates, with six months of very low inflation figures, but the rapid monetary growth of recent months and the prospect of higher inflation in 1984 was an inhibition. He believed that the United States' recovery was set fair in the short run, with a considerable inventory turn-around and surprisingly good housing figures, given how high real interest rates were. The tax cut at the end of June would also boost consumption. His principal worry was the budget deficit, with total savings at around 7 per cent and the budget deficit at around 6½ per cent of GNP. The Federal Government was borrowing $¾ billion per day. The problem would come if the recovery proceeded too quickly and if there were no reduction in the budget deficit. The Prime Minister said that an increase in the taxes on gasolene, alcohol and tobacco would, surely, make a considerable impact on the deficit. Mr. Volcker replied that tax increases on their own would be inadequate: what was needed was, say, a $30 billion defence cut, a $30 billion cut on other spending, and $30 billion in higher taxes.

The Prime Minister spoke of her concern about the international banking situation. There was too much emphasis on the role of the IMF and IBRD, too ready a recourse by debtor countries to these institutions, and too small an impact by IMF and IBRD conditionality on the imprudent and profligate. Mr. Volcker said that this was not the moment to persuade commercial banks to draw back from foreign lending. The risk was the other way, that the banks were drawing their horns in too suddenly and too far. He would not himself criticise the IMF and the IBRD. The sums which they were putting forward were small, and under their aegis debtor countries were being obliged to impose severe economic regimes, with sharply falling GNP and GNP per head in some cases. He was hopeful about the future in Mexico,

/although he

although he believed she had not quite reached the nadir yet. The Brazilians talked well, and were good on paper, but their actions back home were causing a continuing deterioration in Brazil's situation. The Prime Minister enquired whether the assistance the Fed had been giving to Mexico had been a large factor in the growth of US money supply in recent months. Mr. Volcker said that the growth had not been deliberate. He would have preferred a lower growth rate, but one should not become too worried: he did not believe that the growth which had occurred would necessarily lead to higher inflation several years hence.

Mr. Volcker said that it would be important to put in place a proper system of surveillance and control for commercial banks, to prevent a repetition of their present situation in the future. He expressed appreciation of the Prime Minister's support for the British involvement in the measures to deal with Argentina's indebtedness, and spoke of the difficulties for the international monetary system were the Argentinians to repudiate their debts. Chile was currently seeking large-scale support from the United States, and it might be that they would give this support if they could be persuaded that the Chileans would pursue a sensible policy. He was much encouraged by Venezuela's recent decision to go to the IMF; they had long been unwilling even to admit that they were in difficulty, notwithstanding a long-term and ruinous outflow of capital to the United States.

In a brief discussion of oil prices, Mr. Volcker agreed that the price appeared to be stabilised for the time being, and referred to criticisms he had faced in Congress for not supporting a much reduced oil price. For his own part, he believed that another $1, $2 or $3 reduction would not be too disruptive, but that a further fall would be difficult to accommodate. The Prime Minister said that in her view a $3 fall now would be very damaging.

Mr. Volcker enquired what prospects the Prime Minister saw for moves towards greater exchange rate stability, particularly at Williamsburg. The Prime Minister replied that there would not be greater stability until the major countries followed prudent financial policies. She would argue on these lines at Williamsburg, and she believed that such arguments would be still better received this year than in earlier years. Mr. Volcker commented that sticking to a well-conceived financial policy was becoming increasingly difficult since there had been growing restlessness as the recession went on and on. But he believed that within the last three months or so the restlessness had abated somewhat, as the prospect for recovery became clearer. He was facing considerable pressure in Congress to set his monetary policy so as to facilitate recovery. He sought, as always, to add to this formula a requirement that he should do nothing which would re-ignite inflation. But he was not confident that he would secure the inclusion of this essential rider. The Prime Minister said that it would be important that Williamsburg was absolutely clear on this point. Mr. Volcker agreed, and added that he was confident that,

/with the

with the Prime Minister and President Reagan there, the Summit would give the right message.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office), and Richard Hatfield (Cabinet Office).

C. SCHOLAR

John Kerr, Esq.,
H.M. Treasury.

CONFIDENTIAL

FROM: R G LAVELLE

DATE: 13 April 1983

MR KERR

cc: Mr Burns
Mr Bottrill

DISCUSSIONS WITH MR VOLCKER

As background for this visit, I attach a copy of the latest World Economic Prospects brief. US material is sidelined.

2. As you suggested, I have asked the Embassy to send us in the course of the day a summary appraisal of Mr Volcker's testimony yesterday to the House Banking Committee, to supplement the attached FT report.

R G LAVELLE

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FINANCIAL TIMES WEDNESDAY 13 APRIL 1983 (front page)

Volcker stresses need for lower U.S. interest rates

BY PAUL TAYLOR IN NEW YORK

MR PAUL VOLCKER, U.S. Federal Reserve Board chairman, said yesterday that U.S. interest rates were still too high to support a long-term economic recovery, and that if he were a private banker he would be inclined to reduce his loan rates.

Mr Volcker's comments, which had been eagerly awaited by U.S. stock and bond markets, contained few if any surprises. He was testifying before the House Banking Committee on the Fed's monetary policy.

He told Congressmen that interest rates were abnormally high considering the low rate of U.S. inflation and the outlook for inflation in the future.

"If the inflation outlook is as good as I think it is, interest rates are high relative to what is necessary and desirable to sustain a long, healthy recovery. But I would not make the case that in the short run the level of interest rates is incompatible with a business recovery."

Mr Volcker said the markets saw inflationary factors becoming more acceptable but that there was still a "residual concern" that the improvement in the inflation rate might be temporary. This was reflected in longer-term interest rates.

He said interest rates were also affected by the yawning budget deficit which had resulted in the Treasury issuing an average of $750m (£487m) in new securities every day.

In addition, U.S. interest rates were being buffeted by the various changes resulting from financial deregulation.

In spite of these uncertainties, Mr Volcker rejected suggestions that the Fed should establish short-term monetary objectives. Such a move would encourage a "degree of fine tuning" that could be counter-productive to basic economic goals.

With one eye on the markets and economists' concerns about the recent rapid growth in some of the money supply aggregates, Mr Volcker emphasised again that M2 had been distorted by the introduction of new bank accounts.

He said that considering somewhat slower growth in March, M2's growth was very near the upper end of its projected targets and a 7 to 10 per cent annual range still "appears reasonable." The March M2 figure is due to be published on Friday.

Mr Volcker said M1, the narrowest money supply measure, had also been affected by the new accounts and was difficult to assess. M1 had clearly been growing faster than its annual 4 to 8 per cent target range, but he repeated that the degree of uncertainty over interpreting the figures had led to the Fed to place less emphasis on M1 in its short-term monetary policy.

Nevertheless, prolonged growth of M1 at high levels "would be cause for concern."

Summarising the Fed's view of monetary policy, Mr Volcker said: "Taking account of credit as well as monetary behaviour, and some indications that the burst of growth in at least the broader monetary aggregates may be subsiding, we believe our monetary posture has been broadly consistent with the specific objectives we set out in February."

PERSONAL REPRESENTATIVES' MEETING 16-18 APRIL 1983

WORLD ECONOMIC PROSPECTS

Points to make

ECONOMIC OUTLOOK

i. Recovery in world activity not yet fully established. Increase in US GDP and leading indicators, together with revived confidence in Germany, are encouraging but recent firmness in US interest rates and patchy nature of rise in demand emphasise tentative character of recovery so far.

ii. Lower oil prices should, on balance, improve world growth and reduce inflation. Some oil exporting debtors may suffer, more so if prices fall further but benefits to oil-importing countries should outweigh these difficulties.

iii. International financial scene still requires close monitoring. Adjustment process must continue. Most major debtors now have stabilisation programmes with the IMF. Case by case approach is required as blanket solutions would undermine global counter-inflationary strategy. Useful that IMF giving positive lead to commercial banks.

POLICIES

iv. Monetary policy should be flexible but firm enough to prevent any renewed upsurge in inflation. Fiscal policy should aim to achieve a prudent and sustainable structural budget position in the medium term.

v. Policies need to sustain recovery but Williamsburg should resist calls for excessive reflation. Within the framework of prudent financial policies those countries who achieve lower inflation will have greater room for real output growth.

vi. Major countries, especially SDR group, should pursue convergent policies to achieve non-inflationary growth. Only way to exchange rate stability. Welcome recent French recognition.

vii. All countries, particularly Summit partners, need to resist protectionism. Developing countries need access to industrial markets. Trade restrictions inhibit growth and impoverish us all.

Background

ECONOMIC OUTLOOK

Early signs of the modest recovery (1-2 per cent growth in output) forecast for the major industrial economies in 1983 are accumulating. In the US real GDP is estimated to have risen by 1 per cent in the first quarter but so far much of this is attributed to a slower rate of destocking. Industrial production and housing starts have continued rising while in Europe and particularly in Germany business confidence may have turned round. Lower inflation and lower interest rates should help promote the recovery in activity. The fall in oil prices should also increase activity.

2. The US Administration has revised upwards its 1983 projection of growth between the end of 1982 and the end of 1983 from 3 per cent to over 4½ per cent. In Germany private forecasts of GDP growth this year have recently been increased to around 1-2 per cent. But the government while expecting some recovery in 1983 has so far left unchanged its own forecast for zero growth on average in 1983. The French government is now expecting no real growth this year following the recent austerity package.

3. Output growth in the non-oil developing countries (NODCs) after falling last year is also forecast to pick up slightly in 1983 to around 3 per cent though this remains below the 5 per cent growth achieved earlier. World trade is expected to recover only slowly growing by around 1 per cent after falling sharply last year the first fall since 1975.

4. Unemployment is likely to exceed 9 per cent for the major OECD economies by the end of 1983. With the pick-up in activity the rate of increase in unemployment at least may however start to decline towards the end of the year.

5. The year-on-year rate of inflation has fallen faster than expected. For the major countries it has come down from 12 per cent on average in 1980 to 5 per cent this February. Some further fall is likely in the early part of the year but thereafter higher activity may push inflation up somewhat.

6. Nominal interest rates fell markedly late in 1982. In the US three month market rates fell from around 16½ per cent last summer and bottomed out at 8½ per cent by the end of 1982. Since then rates have been broadly flat but over the last month or so they have edged up and now stand above 9 per cent. Elsewhere interest rates recently have generally fallen further (Germany) or remain unchanged (Japan). Although real interest rates have eased slightly they remain high compared to past experience.

7. The OPEC agreement in mid-March to cut prices by 15 per cent to a new marker of $29 pb has held up so far. OPEC's current account may now move into deficit. Lower oil prices should help many sovereign debtors but hurt those who are also oil exporters (Mexico) and may create some extra problems (eg Venezuela, Nigeria, Indonesia, Egypt). A further fall would aggravate these difficulties. On balance the agreed oil price reduction should however improve economic prospects.

8. The large prospective US current account deficit (over $20 bn) dominates the increase in deficits expected this year for the major countries in aggregate. The Japanese current account surplus is running at around $1 bn a month which is higher than the last quarter of 1982 while in Germany January's surplus was over $½ bn. The French deficit improved slightly in February but is already well over a quarter of the government's target for 1983 with only two months' figures available. The Japanese and German surpluses, of $7½ bn and $3½ bn last year, are expected to increase this year.

9. Non-oil developing countries' (NODCs) adjustment last year cut imports sharply thereby reducing their current account deficit from $100 bn to $90 bn. Net new bank lending to NODCs contracted sharply last year - growing by only 9 per cent compared to over 20 per cent in previous years.

10. Financing constraints on NODCs are likely to persist. The IMF expects net new bank lending to grow by only 8 per cent or so in 1983. Import growth may remain depressed but the up-turn in the OECD area should allow some recovery in export growth and some further and sustained improvement in commodity prices. Together with the benefits of lower interest rates this should help NODCs to reduce their current account deficits further to around $70 bn. The recent fall in oil prices should also help.

[illegible]. Exchange rates have remained volatile. After rising sharply last year the effective dollar rate depreciated by around 8 per cent between November 1982 and February this year. But more recently the dollar has strengthened recouping most of this loss as US interest rates have firmed and interest differentials narrowed. As a result of the EMS realignment the DM appreciated by 8 per cent against the French franc ($5\frac{1}{2}$ per cent from the DM revaluation and $2\frac{1}{2}$ from the franc devaluation). Despite the strong appreciation since last November which has reversed the losses in 1982 the yen remains undervalued.

12. Most major debtors including Mexico, Brazil and Argentina are now implementing stabilisation programmes with IMF assistance. Although the imminent threat of major international defaults has receded financing difficulties still persist. The $47\frac{1}{2}$ per cent increase in quotas (from SDR 61 bn to SDR 90 bn) agreed at the IMF's February Interim Committee together with the increase in the General Arrangements To Borrow and its greater availability should enable the Fund to play an effective role in helping countries to adjust their economies. The World Bank needs its resources replenished (See Annex on IDA).

13. Several new initiatives have been proposed to ease the banks' present difficulties with sovereign lending. Some of the schemes involve a new international institution taking over responsibility for some country lending by banks. All involve public money without reinforcing conditionality and none so far has attracted support from other major countries. The arguments for a new SDR allocation will need to be carefully considered. The IMF will be studying them later this year (July). The UK has an open mind but doubts if an unduly large allocation will be justified.

POLICIES

14. The operation of monetary policy last year was complicated by institutional change and shifting liquidity demands. Last year US monetary growth overshot the targets partly due to distortions. In February the Fed announced higher targets for 1983, but stressed its counter-inflationary goal.

[illegible]. Reports of the February FOMC meeting suggest the Committee was divided over monetary policy with some arguing for a tighter stance. Earlier this year all the monetary aggregates were growing rapidly well above their respective target ranges. But there are signs that the expected slowdown in growth may be occurring. M3 growth slowed in February and is now just slightly above its $6\frac{1}{2}$-$9\frac{1}{2}$ per cent target. More recently the level of M1 has actually fallen and growth has contracted sharply. Despite this the latest figures indicate M1 grew at around 15 per cent pa over the period since Q4 1982 as a whole which is considerably in excess of its 4-8 per cent target.

16. Last year monetary growth (CBM) in Germany at around 6 per cent was towards the top end of the 4-7 per cent target range. The same target has been set for 1983 despite lower inflation. In the first two months of the year CBM has grown at over 10 per cent pa, well above target, partly as a result of temporary factors. In France although domestic credit expanded rapidly in 1983 the external deficit enabled the monetary target to be met. The government has announced a tighter target for 1983. It has moved to a single figure objective which has just been reduced from 10 per cent to 9 per cent. Italian monetary control last year was wrecked by the high public sector deficit. No new target has been set for 1983.

17. As regards <u>fiscal policy</u>, since 1979 despite most government's attempts to achieve firm public expenditure control, general government deficits have risen, mostly due to the recession, from 2 per cent of GDP in 1979 to over 4 per cent in 1982. Only Japan and the UK have secured a reduction in their deficits while of the remaining major countries Germany has made the greatest efforts to keep deficits down. Mildly expansionary policies in France and the US have, along with the recession, tended to increase budget deficits.

18. Last December OECD estimated that deficits for the major economies this year would remain at 4 per cent of GDP despite the expected recovery. The new French measures to accompany the devaluation are designed to keep the central government budget deficit in 1983 <u>and</u> 1984 to 3 per cent of GDP. The restrictive 1983 budget introduced by the Japanese Government has been tempered but only slightly by the concession of income tax cuts later this year, the financing of which has yet to be decided, and the acceleration of public works programmes.

19. The US Administration estimates that the budget measures for FY1984 should reduce the Federal deficit from $6\frac{1}{2}$ per cent of GDP in FY1983 to $3\frac{1}{2}$ per cent by FY1986. But these deficits would still be high compared with past experience and depend on rapid growth being achieved. The budget measures are still being debated and have yet to be passed by Congress. So far at least the budget has not entirely satisfied concern over the Administration's future fiscal stance.

PROCEDURE

20. We share the hopes for a relatively informal discussion at Williamsburg concentrating on a few key economic issues. But there is already considerable pressure notably from the French and the Scandanavians, for some co-ordinated reflation by the major low inflation countries. Such expectations need to be defused in advance of the Summit. Lower inflation should, within the bounds of prudent counter-inflation policies, allow greater real growth. But there is scope for a better policy mix to ensure a more balanced and sustainable recovery. In particular the US should be encouraged in its efforts to reduce its budget deficit while there is a need for high inflation countries such as Italy and France to bring their performance into line with that of their Summit partners.

21. As yet there has been no call for a macro-economic assessment paper examining prospects and policies similar to the one produced for Versailles. It might however be useful to consider whether there should be a short note on the latest position which could be prepared after the OECD Ministers' meeting.

12 April 1983

ANNEX

INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

Points To Make

Prospects for Congressional approval of US contributions to IDA 6 in FY 83 and FY 84 are causing anxiety. Hope that US Administration will make major effort to secure approval. Failure would have serious implications for future of IDA and would damage developed countries' position in North-South dialogue. Would be particularly unfortunate in context of UNCTAD VI.

2. Hope also that US will be flexible on the size of its contribution to IDA 7. Important for all donors to contribute in accordance with their economic strength.

INTERNATIONAL DEVELOPMENT ASSOCIATION

ESSENTIAL FACTS

IDA was established in 1960 as an affiliate of the World Bank. Its credits are provided on near grant terms to the poorest countries in the world.

IDA 6

The Sixth Replenishment (IDA 6) was originally intended to provide $12 billion for commitments in three fiscal years beginning 1 July 1980 (FY 81), but the Carter Administration was unable to obtain Congressional authorisation for the US contribution ($3.24 billion - 27%). The present US Government decided to accept the commitment but to phase payment over 4 years instead of three (ie to FY 84). Only $1.9 billion has so far been authorised by Congress and there is a serious risk that the US contribution will not be complete until the fifth year (FY 85). Other IDA donors have agreed to provide IDA with additional commitment authority over the extended 4 year period - first by advancing their first year's IDA 6 instalments, then by delinking their second and third year's instalments from the level of the US contribution, and finally by agreeing special funding for FY 84.

The Reagan Administration is seeking supplementary appropriation of $245 million for FY 83 and the $1095 million balance in FY 84. It is common ground that every opportunity should be used to persuade them to make a major effort to secure Congressional approval for these appropriations. Resulting from a UK initiative, the German Ambassador in Washington delivered a European Community demarche of 1 March. IBRD President (Mr Clausen) in London 12-15 April will ask Prime Minister to raise this with Reagan personally at Williamsburg.

IDA 7

Negotiations on the seventh replenishment began in Washington last year with the intention of reaching agreement by the time of the September 1983 Annual Meeting of the IMF and World Bank. Meaningful negotiations cannot begin until the US position under IDA 6 is clarified, and the size of the US contribution to IDA 7 is known.

UK Interest

The UK has been a strong supporter of IDA under successive Governments and our interest is probably to work for a continuing high level of resources for IDA, but towards an IDA 7 replenishment target that is realistic and includes full US participation. It would be futile to fix an overall volume which the US Administration could not meet or to start IDA 7 without the US. At the present time the US Administration is thought to be considering contributions of around $750 million a year which would produce an IDA 7 total of $9 billion over 3 years or $12 billion over 4 years - substantially less in nominal terms than the agreed total for IDA 6.

On burden sharing, we have already made clear our intention of reducing our share from the very high level of 10.1 per cent for IDA 6, and from the 7.6 per cent for the special funding for FY 84, to one more in line with UK's relative economic strength.

TO BE MUFAXED TO CHEQUERS

PRIME MINISTER

Paul Volcker

The Foreign Office tell me that Mr. Volcker will be in London on Thursday 14 April. He will be seeing the Chancellor in the afternoon and will be having dinner with the Governor of the Bank of England.

You have no time to see him in the morning, and the afternoon is full of meetings until 1800. If you wanted to see him, the only possibility would be to have a drink with him at about 1815.

Do you want to do this?

Yes please

CR

7 April 1983

This has been fixed for 1815 on 14/4.

8/4

Note/ Asked Tsy to let me have a copy of the Ch/Ex's brief, and to prepare a brief for the PM if they wished to.

11/4

SUBJECT.

file K6

Prime Minister

10 DOWNING STREET

From the Private Secretary

12 February 1981

Dear John,

As you know, Mr. Paul Volcker, Chairman of the Federal Reserve System, called on the Prime Minister at 0900 hours on Wednesday, 11 February. The Chancellor of the Exchequer and Sir Kenneth Couzens, and Mr. Ahmerman from the U.S. Embassy, were also present.

Mr. Volcker described the current economic situation in the US as he saw it. In his view, some of President Reagan's advisers were being overly optimistic on the tax front. Unless there were early and substantial public expenditure cuts, he doubted whether there would be scope for tax reductions on the scale which they envisaged. The President should be giving the American people greater warning of the difficulties that lay ahead. It was very unlikely that the acceleration in GNP growth in the fourth quarter of 1980 could continue, as was being suggested in some quarters. For if the current monetary targets were to be hit, there was little or no scope for any real growth in the economy. The money supply had been rising at a rate slightly faster than the target range, and they had taken steps to curb it. But the consequence was high interest rates, and even now this was putting a damper on economic expansion. With a big budget deficit in prospect, pressure on the money markets was likely to continue. He feared the prospect of some sizeable bankruptcies, which in turn could put some of the financial institutions at risk. In addition, there were the uncertainties about future oil prices, and the possibility of a bad winter wheat crop because of insufficient rain. If there was to be a real recovery, inflation had to be reduced. It would be better for the new Administration to "hit hard and fast" in order to achieve this. The question which everybody in the US was asking was whether a turn-around in inflation was possible without the economic squeeze which the UK had experienced.

The Prime Minister said that she thought the scope for achieving reduced inflation without a major squeeze was better in the case of the US than it had been for the UK. Here, our difficulties had been aggravated by the world recession and by the high exchange rate; but also, wage inflation was more built in to the system. Years of incomes policies, and the assumption of automatic annual pay increases, made it more difficult to curb the growth of earnings. Mr. Volcker said on the latter point, that the US was having its difficulties too.

/The existence

The existence of three-year pay contracts was a mixed blessing at a time when the Government was trying to disinflate. For example, the auto workers had just signed a contract which would give them 40 per cent over three years. Also, in those sectors of the economy such as the defence and energy industries which were booming, wages were going up very fast. On the other hand, the public utility unions were probably less strong than their counterparts in the UK.

There was some discussion of monetary control issues. Mr. Volcker said that the financial markets were much more complex and erratic than existing theories suggested, and therefore they were harder to protect. But the FED had done a great deal of work in trying to improve their understanding of these matters and their techniques of market management. They were now reasonably confident that they could hit their monetary targets on a quarterly basis two-thirds of the time with a margin of plus or minus 10 per cent. But it was doubtful whether the interest rate consequences could always be borne. Control had been improved as a result of the auction system for debt which he had introduced. Auctions allowed the Treasury to sell the amount of debt that they desired, and he did not believe that they had been greatly responsible for the recent interest rate volatility. The latter was primarily due to other forces. There were some disadvantages - for example, the authorities could no longer give signals to the market in the way that the Bank of England was able to. But the advantages outweighed the disadvantages. The Prime Minister said that she thought the US experience with auctions could be very relevant for the UK, though we would be concerned if we had as much volatility as the US bond market appeared to display.

Finally, Mr. Volcker reported on some conversations he had had in London and in Europe over the previous day or two. He had found a scepticism in the City which he had not found previously about the different measures of the money supply, the setting of targets and the authorities' ability to meet them. Businessmen to whom he had spoken in London seemed to be getting pretty nervous: they had sympathy for what the Government was trying to do, but they now wanted a little hope - particularly on the exchange rate and interest rate front. In his conversations with bankers in Zurich and Barcelona, he had found increasing concern that the world was moving into deeper recession; and there appeared to be an increasing number of people who were advocating reflation. Even in Germany, people were beginning to take this line. He had also found growing concern about the problems of the LDCs. Many LDCs were in fact facing a very difficult situation because of higher oil prices and because of the very high interest rates which they were paying on their external debt. Countries such as Brazil had not reckoned on interest rates staying high and world inflation moderating when they took on their debt.

I am sending a copy of this letter to Tim Allen (Bank of England) and George Walden (Foreign and Commonwealth Office).

Yours ever,

Tim Lankester

A. J. Wiggins, Esq.,
H.M. Treasury.

1. SIR KENNETH COUZENS
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Middleton
Mr Hancock
Mrs Hedley-Miller
Mr Bottrill
Mr Turnbull
Mr Whitmore(No.10)

MEETING WITH MR VOLCKER

Together with the Prime Minister you are seeing Mr Volcker on 11 February. Two briefs are attached. The first covers U.S. economic and monetary policies; the second deals with UK financial policies.

2. The meeting provides an opportunity to seek Mr Volcker's views on:-

(i) the policies of the new Administration (Mr Volcker has said that tax reductions in advance of public spending cuts might not be consistent with reduced pressure on financial markets).

(ii) U.S. economic prospects (the U.S. inflation rate, now on the way up again, might soon meet the UK inflation rate on the way down).

(iii) the operation of U.S. monetary policy.

3. Although methods of monetary control differ between the U.S. and the UK there are similarities in overall approach. It is jointly recognised that no one monetary aggregate can be an adequate guide to policy. And that short-term deviations from trend, or in the relationship between money supply and other economic variables need not be harmful.

4. In each country the interpretation of monetary policy has been complicated: in the UK by the corset, and in the U.S. by the growth of new banking facilities which are blurring the distinction between various types of money.

5. Mr Volcker is likely to ask about UK policies. You may wish to administer an antidote to recent criticism in the U.S. press and elsewhere.

6. You will be supported at the meeting by Sir Kenneth Couzens.

M.C. Mercer.

M C MERCER
10 FEBRUARY 1981

KEC 10/2

US ECONOMIC INDICATORS

GNP in 1980 fell by around 0.1 per cent. The decline in the second quarter (9.9 annual rate) was a post-war record. Some recovery in second half of the year, but chance of a renewed fall in activity in first half of 1981 remains.

Consumer prices accelerated sharply at the end of 1980 with a rise in the last quarter of over 12 per cent (annual rate). Higher mortgage rates were only partly responsible. Earnings growth is now starting to pick up. Hourly Earnings in December were 10.5 per cent higher than a year earlier.

Unemployment has been fairly steady at around 7.5 per cent for the last year or so but is officially expected to reach 8 per cent in the first half of 1981.

The current account was almost certainly in surplus last year for the first time since 1976. Compared with 1979 the improvement was almost entirely on trade account with a 17 per cent or so reduction in the volume of oil imports more than offsetting higher oil prices.

PRIME MINISTER'S AND CHANCELLOR'S MEETING WITH MR VOLCKER

DRAFT BRIEF NO.1 : US DEVELOPMENTS AND POLICIES

1. i. What are prospects for US output (can recent recovery be sustained?); and inflation (UK rates may well now be falling below US rates).

ii. Might US tax cuts boost government borrowing before public spending cuts begin to bite? Effect on interest rate if this happens and inflation accelerates.

iii. Interested in US experiment with monetary base control. Has it led to higher/more volatile rates than necessary? Effect of volatility on inflationary expectations, business confidence? European complaints about effects on EMS currencies?

iv. What have been main operational problems in setting targets and controlling bank reserves?

BACKGROUND

Policies of new Administration

2. Main economic measures proposed by Reagan are : 10% personal tax cut in each year 1981-83; corporate tax concessions; 2% cut in federal outlays in 1981.

3. Growing concern about timing and impact of tax and public expenditure proposals. Policy statement expected mid-February. Volcker has urged "concrete action" on public spending before taxes are cut. Others, notably Stockman, say early tax cuts are imperative to stimulate economy and help reduce budget deficit through higher economic activity. Expenditure cuts will not be easy. A 2% reduction implies a 16% cut in those programmes that can be trimmed (ie those that are not demand determined or bound by statute).

4. Federal deficit for 1981 officially forecast at $55 billion (around 2% of GNP); with federally backed loans etc it could reach over $70 billion. Reagan's proposed tax cuts would cost around $30 billion in 1981 (about half of expected fiscal drag); a 2% public expenditure cut would save some $15 billion. Danger of fiscal/monetary imbalance as large federal financing needs compete with private credit demands. And economy grew fast (5% annual rate) in Q4 of 1980.

US Monetary policy: Techniques and problems

5. New techniques introduced in October 1979 seek to control growth of monetary aggregates by restricting supply of reserves to the banking system. Not pure monetary base control. Interest rates not completely free but allowed to fluctuate within wide margins.

6. Techniques applied through open-market operations. Fed buys and sells securities to provide volume of non-borrowed reserves thought consistent with money targets. If money supply moves above target banks need to top up reserves. They are encouraged to use Fed discount window only as a last resort and to look for other sources of funds first. In this way reserve pressure pushes up money market interest rates (the Fed funds rate is the trigger) and so affects bank lending and money supply growth. If money supply fails to come back on course the Fed can squeeze the supply of non-borrowed reserves further.

7. Two main problems in practice: what targets to choose and how to define them; and how to react when relationships between bank reserves and money supply appear to shift.

a. Choice of target

8. Trade-off between Fed's ability to control a given aggregate and influence of that aggregate on overall demand. Monetary base easiest to control but weak relationship to overall demand. Broad aggregate such as M2 has more stable relationship but hard to control. Narrower aggregates fall inbetween.

9. Problems of definition a further complication. US financial system evolving rapidly. Growing availability of new instruments and banking facilities blurring distinction between various forms of money. Fed has opted for flexibility. Family of targets:

MIA - Currency plus demand deposits

MIB - MIA plus other checkable deposits (eg recently authorised "Negotiable Order of Withdrawal" accounts which are interest bearing).

M2 - MIB plus banks' overnight repurchase agreements, savings and small time deposits.

Volcker recently said "No single monetary measure should be emphasised to the exclusion of others, nor should undue weight be placed on short-term changes or small deviations from targets, particularly when those deviations are not consistent from one measure to another."

b. <u>Relationship between bank reserves and money supply</u>

10. Fed nonetheless has problem of distinguishing between self-correcting money supply fluctuations and more fundamental shifts. It periodically sets short-term (1-2 months) targets during the year and manages reserves on day-to-day basis. Procedure designed to avoid unnecessary market disruption (many say it has failed in this): while responding early to serious money supply slippage.

11. One difficulty has been unpredictable relationship between reserves and money stock. Different money stock components have different reserve requirements: some have none at all; many banks have left the Federal Reserve system to avoid requirements. Uniform requirements are being applied to all deposit taking institutions but this will take 8 years.

12. Another difficulty has been Fed's limited ability to achieve reserves targets. Forecasting errors and faulty or erratic management of the discount window have been blamed. Reforms to increase Fed's control over reserves are being considered.

Recent monetary developments

13. Partly for these reasons, new techniques have had teething problems. But Volcker attributes last year's volatility of interest rates and money supply mainly to parallel volatility in the overall economic environment (cf GDP fall in Q2 1980 at 10% annual rate, rise in Q4 at 5%).

14. US interest rates (3 month CD rates) rose from 10% in February 1980 to 18% in April, fell to 6% in June, rose to 20% in mid-December and have since fallen back to around 17%. Money supply (MIB) fell in the second quarter of last year and grew rapidly for much of the second half. For the year as a whole MIA and MIB grew at the upper end of target ranges (3½-6% and 4-6½% respectively); M2 slightly exceeded its 6-9% range.

15. Europeans complain about the effects of high and volatile US interest rates on the German mark and other European currencies. They see US monetary policy as adding to their inflation by weakening their currencies, and to their unemployment by keeping up European interest rates. But they can hardly complain about US determination in fighting inflation.

Prospects

16. All targets for 1981 provisionally cut by ½%. Fed to reassess them in mid-February. Early interest rate decline might be limited by several factors:

i. Heavy Treasury financing requirements - estimated at about $25 billion in first quarter.

ii. Probable Fed unwillingness (even if economy goes into recession again) to see repeat of rapid interest rate decline of last spring.

iii. Prospect of double figure inflation persisting through most of 1981.

PRIME MINISTER'S AND CHANCELLOR'S MEETING WITH MR VOLCKER

BRIEF NO.2 : UK FINANCIAL POLICIES

Introduction

1. Mr Volcker may seek to establish where the UK Government stands on its financial policies. He could ask:

i. What caused the overshoot of £M3?

ii. Why had the Government nevertheless felt able to reduce interest rates?

iii. Does the Government intend to continue its monetary strategy or is it veering towards some kind of exchange rate objective?

iv. What problems are the Government experiencing in reconciling fiscal and monetary policy?

Points to make

2. The Government remains fully committed to its monetary strategy by which inflation will be reduced by a progressive reduction in the growth of money. Intend to stick to monetary targets - no intention of switching to an exchange rate regime or modulating monetary targets according to the level of the exchange rate.

3. Government accepts that, if allowed to continue for long, rapid growth of £M3 would have serious consequences. Relationship between money and prices well established over an extended period. But after a burst of growth in the late summer, rate of increase of sterling M3 has been falling back. Short term variations need not have harmful effects. Programme for reducing inflation is a medium term one and in that timescale it remains our intention to reduce the growth of the money supply.

4. Special factors have inflated growth of £M3. Problem of corset similar to problem of changing financial structure in US - see Brief 1, para.9. Other factors have been:

i. high PSBR, reflecting recession (nationalised losses, faster procurement spending, more benefit payments, lower-tax yields);

ii. imbalance between personal and company sectors; three excessive pay rounds plus a high exchange rate, high interest rates and a sharp recession produced heavy company bank borrowing and a 17% personal savings ratio. Unprecedented extent to which personal savings and company borrowings channelled through the banking system probably added to demand for £M3 and inflated figures.

5. Notwithstanding high growth of £M3, Government have felt able to make some reduction in interest rates in view of evidence of monetary tightness from many other indicators (rapidly falling inflation, strong exchange rate, slow growing narrower aggregates, general state of economy). But formulation of monetary objectives for coming period now under consideration as part of March 10 Budget.

6. Government intends to continue using £M3 as its main target variable, but agree with Volcker's remarks (Brief No 1, para 9) that no one aggregate can be adequate as sole guide to policy. While we do not intend to adopt multiple targets, Government will take account of narrower aggregates alongside £M3 in conduct of policy.

7. Acutely aware of potential conflict between fiscal and monetary policy. This is heightened by use of broad aggregate as principal target variable - indeed that is an important argument for continuing with £M3. Fiscal measures were taken in November, and Budget will provide further opportunity to bring borrowing requirement into line with needs of monetary policy.

8. Seen some tendency in US press to say "Thatcher experiment failed". Maybe some saying it because would <u>like</u> it to be true. But it isn't. Policy very much alive and inflation falling faster than in other major countries. Is being pursued with determination.

<u>Background</u>

9. A separate note will be submitted on the provisional money supply figure for banking January, which will be published on Tuesday, 10 February.

JBH 9.2.81

PM

PRIME MINISTER

Mr. Paul Volcker, Secretary of the Federal Reserve Bank is to be in London on 10/11 February. The Chancellor is keen that he and Mr. Volcker should see you together. Do you agree to my finding a 45 minute slot?

Yes MT

If you agree to see him here does this make the meeting already arranged in Washington with him unnecessary?

Yes MT

CS.

27 January 1981

arranged for Wed. 11th Feb. at 0900. Treasury will send briefing. M.A. informed of 2nd para. CS 27/1.

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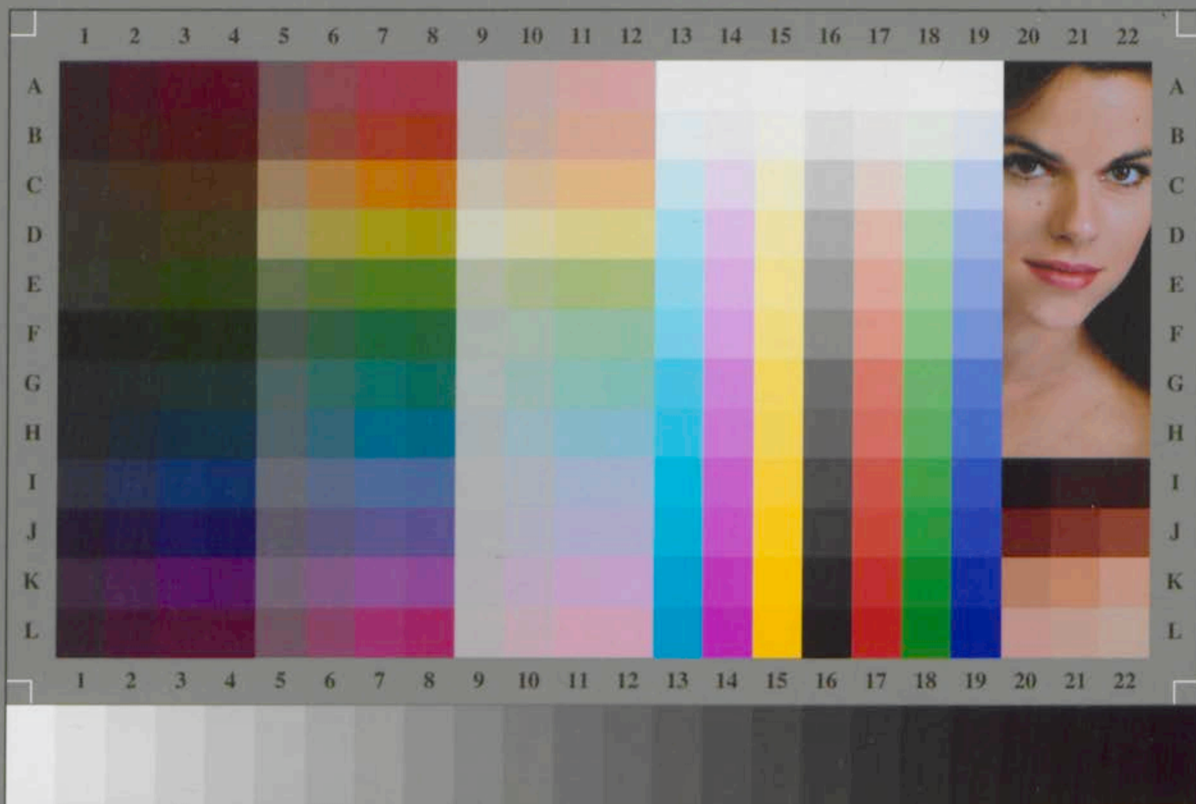

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