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RECORD OF A MEETING HELD IN BLAIR HOUSE, WASHINGTON DC, AT 1735 ON MONDAY 17 DECEMBER 1979

Present:-

Prime Minister
Sir Robert Armstrong
Mr. W.S. Ryrie
Mr. M.A. Pattison

Mr. Paul Volcker, Chairman of the Board of the US Federal Reserve System

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US Monetary Policy

The Prime Minister said that she would be interested to hear about the apparently dramatic change in United States' monetary policy. The United Kingdom operated with five different indicators. M3 was not a true one, as acceptances were outside the system. Mr. Volcker replied that the United States had found no "Holy Grail" to solve monetary problems. They also worked with a variety of indicators. But they did have to cope with more factors outside the formal banking system. The newest gadget of this kind was money market funds: they were not subject to regulation, but their function created money. They were, however, outside the money supply figures. There was a pedagogical advantage in concentrating on the money supply, especially in Washington. For a US administration, it would be very hard to adjust interest rates overtly, although the problem might be decreasing. The Federal Reserve had declared the intention of controlling money supply, with the implication that they would no longer attempt to control interest rates directly. This presentation was politically acceptable. But if they had said they were putting interest rates up two or three per cent, this would not have been politically acceptable. Nevertheless, the discount rate was too important in setting interest rates for it to be allowed to float at present.

/Mr. Volcker

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Mr. Volcker said that it had seemed technically better to get money supply under direct control. It was too early to judge results, but M1 (cash in circulation plus current accounts) had levelled off from monthly growth indicating 10 per cent annual growth to a 1½ per cent figure. This was below what the administration wanted. The Prime Minister commented that this was an attractive position at a time of 15 per cent inflation. Mr. Volcker responded that the administration was now discovering that the relationships between money supply and inflation were not as direct as they might have hoped to see. The Prime Minister asked what time-lag there was before the rate of inflation followed the trend of money supply. Mr. Volcker said that it tended to be about 18 months, although there were considerable variations. US M3, similar to the UK M3 measure, was rising at about 7-8 per cent. The Prime Minister asked whether this relatively low growth in M3 meant that borrowing figures were down. Mr. Volcker said that this was not true of Government borrowing but was true elsewhere in the economy. But the United States did not have a particularly close relationship between money supply and interest rates.

Mr. Volcker said that there was a political dilemma in the present position. Money supply was growing slowly, as the economy moved into recession; there would be calls for a change in the money supply target. Interest rates would go right down, and this could weaken the dollar. The Prime Minister compared the different problems faced by the United Kingdom in managing a petro-currency at a time of high interest rates. The high interest rate could be acceptable if borrowing could be cut down. The Government had expected the 14 per cent minimum lending rate to grip within a period of about 4 months. This had not happened. She personally had always tended to be cynical about forecasts, and now regretted following forecasts too closely at the expense of watching what was actually happening. Mr. Volcker said that there was now a period of minimal money supply growth, and there had been pressure to increase this. The Federal Reserve had resisted this. But he felt that it was dangerous to become too wedded to any money supply figure. The Prime Minister commented that it was dangerous to become fixed on any very specific target.

Mr. Volcker said that he could not predict how the combination of high interest rates and reducing M3 would work out. He asked whether the morning's White House discussions had touched on the United Kingdom's 7 per cent rise in VAT, and the impact of this on consumer prices. The administration were now considering a 50 cent a gallon gasoline tax, which would have a similar effect on consumer prices. It was a delicate political judgement. In areas like this, the United States could learn from British experience. On incomes policy, too, the United States watched with considerable interest problems encountered in the United Kingdom in recent years. The Prime Minister emphasised forcefully the dangers in any attempt to introduce a detailed wages policy.

Iranian Assets

The Prime Minister asked about the blocking of Iranian assets. It was her understanding that Iran had threatened to default as well as to withdraw funds from United States banks, and that this threat provided a banking reason for action to protect the assets. Although she understood that this had been the initial position, the US administration later seemed to have switched to blocking the withdrawal of assets whilst the hostages were held, essentially as a political option. There had been requests for the British Government to do the same, but all advice had been that there was no legal basis in the UK for such blocking action on political grounds: only banking grounds could justify it. The situation would change if the United Nations were to reach a Chapter 7 determination, when sanctions would have legal force in the United Kingdom. Mr. Volcker stressed that he personally had not been closely involved in the decision. The blocking of assets had not been initiated in the face of political problems, but only when the Iranians threatened to withdraw the assets and hinted that there might be some action on the loan. Since then, the Iranians had by and large respected their obligations on loans from elsewhere, but the action of blocking assets had been treated as one of the political options available to the US and her allies. They were well aware that it was an unsatisfactory and vulnerable position to try this option without comparable steps being taken by others. There were dangers in the possibility of a lack of uniform reaction from the industrialised world. The Chapter 7 approach was another option, but with disadvantages including the time required and the veto problem. The Prime Minister doubted that the USSR would veto a sanctions resolution; but the Security Council was now a disparate group and delicate drafting would be needed to secure the required support.

Mr. Volcker said that another alternative, short of freezing assets, would be to encourage US banks to check that Iran was punctilious in service on existing loans, whilst also discouraging new loans. Some other countries were encouraging their banks to look at finance for Iran in this way. The Prime Minister acknowledged that the essence was to act in concert. It would be all too easy for individual actions to destabilize the world banking system. Mr. Volcker said that, given Iran's present posture, joint steps were vital. He was aware of some technical concerns in the Bank of England, but did not know the details. The Prime Minister commented that there were some 300 foreign banks in London now. Mr. Volcker acknowledged that this was a rapid and significant development. He did not see any likelihood of a threat to it.

Oil Producers' Balances

The Prime Minister expressed her concern that the huge scale of current liquidity in the international banking system would inevitably fuel inflation in some part of the world economy. Mr. Volcker was worried about the funds to be absorbed following the latest round of oil price increases. Percentage rises were now much less dramatic figures, but the rises were on a very much larger base than those of 1973/74, producing a volume just as large. There could be major problems in getting all this re-cycled. The Prime Minister shared these concerns. The situation was made bleaker by the growing ability of the producers to preserve their incomes whilst regularly decreasing their oil output. Mr. Volcker recalled that in 1973 there had been talk of the IMF working much more closely with the commercial banking sector. Nothing significant had come of this at the time, but the prospects would now need to be re-examined carefully.

International Consultation

Mr. Volcker commented on changes in international monetary affairs which he found on returning to Washington after a five year absence. The process of consultation, and the open exposure of problems to discussion and advice from all sides, were much more common place than in the past. This was encouraging. But the scale of problems were now much greater. When it came to facing the basic issues, this new scale made it much more difficult to work through major difficulties in partnership, without being side-tracked by the initial gut reaction of placing national interests first - this was well illustrated by the oil stock piling which had gone on in the last six months despite absurd spot market prices. Mr. Volcker drew some encouragement from the signs that countries were avoiding self-seeking action on the trade front.

The meeting concluded at 1755.

19 December 1979