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10 DOWNING STREET

From the Private Secretary

16 November 1982

Call by Dr. Alan Greenspan

Dr. Alan Greenspan called upon the Prime Minister this morning. Dr. Greenspan said that the Western economies were moving into a difficult time. Re-adjustment to a world with much lower inflationary expectations was not a painless process. There would continue to be problems with individual countries: in the case of Mexico, for example, although conclusion of the agreement with the IMF was a major step, it remained to be seen whether the Mexicans would live up to the programme to which they had put their names. We were now seeing a reduction in the size of the Eurocurrency market, and borrowers would face a difficult time as the expansion of credit came to a halt. Banks had now recognised that some of their lendings would never be recovered - for example the Polish loans. There would also be troublesome secondary effects: a country like Bolivia, for example, might experience difficulties as payments to it from, for example, Argentina, were delayed. We had seen little of such effects so far. His conclusion was that the next six months would be critical.

The Prime Minister enquired about the prospects for the US economy. Dr. Greenspan said that he did not expect a turn before February or March. There had been good progress on the budgetary and inflation front, and in his view it would be only when the long-term budget prospects were clearly under control that long-term interest rates would come down from their present excessively high levels. The Prime Minister commented that the Administration had two clear years before the Presidential Election; it needed to take action now. Dr. Greenspan referred to the Congressional problems which the Administration faced, and said that the position had not been made easier by promises which were made during the recent Election campaign. The next six months on this front, too, would be decisive. He had been engaged, as Chairman of a Bi-Partisan Commission on Social Security, in working for an agreement on these issues which would be acceptable to the Administration and to Congress.

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If the long-term budget deficit could be brought down from \$200 billion to, say, \$125 billion, that would be a great achievement. The Prime Minister said that she doubted whether the Administration would be able to cut expenditure quickly enough to produce a sufficiently quick effect on the budget deficit. As she saw it, something would have to be done about the revenue side. This, after all, had been the inevitable conclusion to which her own administration had been obliged to come. Dr. Greenspan agreed, and spoke of the benefits, in terms of increased investment, which would arise as inflation fell.

The Prime Minister referred to the flatness of the UK economy this year. Dr. Greenspan said that he had never subscribed to the locomotive theory, but he did not believe that there could be a buoyant world economy when the US economy was in deep recession. It was the shrinking of the world economy at the end of 1981 and earlier this year which, in his view, had stifled the beginnings of recovery in the UK. But he believed that there had been a very great improvement in the underlying economic situation in the UK, and that when there was an improvement in world trading conditions the UK would move ahead faster than many other countries.

The Prime Minister enquired about Dr. Greenspan's view of recent monetary events in the United States. Dr. Greenspan said that he believed that the Fed had relaxed their monetary stance somewhat, partly because of their worries about international financial fragility. As he read it, Mr. Volker believed that the recent easing in inflationary pressures left him room for some relaxation of policy; and that if he tried to push down the money supply bulge short-term interest rates would rise sharply, with unfortunate consequences. This modification of policy was merely a tactical move, and the monetary strategy remained intact.

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

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

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