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INFO BONN, PARIS, ROME, OTTAWA, TOKYO AND UKDEL OECD

MR VOLCKER'S TESTIMONY ON MONETARY POLICY

SUMMARY

1. MY TELNO 2139 SUMMARISED THE MAIN FEATURES OF THE FEDERAL RESERVE BOARD'S LATEST (SEMI-ANNUAL) MONETARY POLICY REPORT. USING THIS DOCUMENT AS A QUOTE FRAMEWORK UNQUOTE FOR HIS COMMENTS, MR VOLCKER TODAY GAVE HIS TESTIMONY TO THE HOUSE BANKING COMMITTEE. (COPIES OF THE REPORT AND TESTIMONY WILL FOLLOW BY BAG). THE TESTIMONY WAS FAIRLY UNEVENTFUL AND ADDED LITTLE TO WHAT IS IN THE REPORT. BUT IT WAS WELL RECEIVED BY THE COMMITTEE: AND SEEMS TO HAVE REASSURED MARKETS THAT THE REBASING OF M1 IS ESSENTIALLY A TECHNICAL CHANGE AND THAT MONETARY POLICY GENERALLY REMAINS ON COURSE. VOLCKER, HOWEVER, WAS CRITICAL BOTH OF THE ABSENCE OF A SOLUTION TO THE US BUDGETARY PROBLEM AND OF OTHER DEVELOPED COUNTRIES' FAILURE TO PROVIDE SUFFICIENT SUPPORT FOR THE WORLD'S RECOVERY.

DETAIL

2. KEY POINTS EMERGING FROM TODAY'S SESSION ARE AS FOLLOWS:-
- VOLCKER POINTED TO THE SHARP CONTRAST BETWEEN MARKET SLUGGISHNESS IN THE GOOD-PRODUCING SECTOR OF THE ECONOMY AND RISING DOMESTIC CONSUMPTION AND DEMAND. AGAINST THIS BACKGROUND, AND THAT OF RELATIVELY WELL CONTAINED INFLATIONARY AND COST PRESSURES, THE FEDERAL RESERVE HAD ADOPTED A GENERALLY QUOTE ACCOMMODATIVE UNQUOTE APPROACH IN THE PROVISION OF BANK RESERVES.
 - FOR THE TIME BEING, TAKING INTO ACCOUNT ALL CURRENT AND LIKELY ECONOMIC DEVELOPMENTS, THE DOWNWARD PRESSURES ON COMMODITY PRICES AND THE HIGH LEVEL OF THE DOLLAR, THE GROWTH IN M1 AND DEBT DID NOT IN ITSELF JUSTIFY A MORE RESTRICTIVE MONETARY STANCE.
 - AT THE CURRENT LEVEL OF EXCHANGE RATES - STILL ABOUT 60 PERCENT ABOVE THE RELATIVELY DEPRESSED LEVELS OF 1979 AND 1980 - PROSPECTS FOR STEMMING DETERIORATION IN THE OVERSEAS TRADE POSITION, MUCH LESS ACHIEVING A TURNABOUT, REMAIN UNCERTAIN. MUCH DEPENDS UPON THE RATE OF GROWTH IN OTHER COUNTRIES. THOUGH THE DOLLAR WAS STILL OVERVALUED, VOLCKER SAID HE DID NOT FAVOUR A SUBSTANTIAL FALL IF THIS REFLECTED QUOTE LACK OF CONFIDENCE IN THE US ECONOMY AND ECONOMIC POLICIES UNQUOTE.
 - THE QUOTE BROAD POLICY CHALLENGE UNQUOTE IS TO DEAL WITH A SITUATION MARKED BY GROSS IMBALANCES - INTERNAL AND EXTERNAL - THAT CAN NEITHER BE SUSTAINED INDEFINITELY NOR DEALT WITH SUCCESSFULLY BY MONETARY POLICY ALONE.
 - IN INTERPRETING RECENT MONETARY DEVELOPMENTS, THERE ARE PARALLELS - THOUGH NOT EXACT ONES - WITH 1982/83, WHEN M1 WAS ALSO REBASED. ONE IMPORTANT COMMON FACTOR AT WORK IS THAT THE RAPID GROWTH IN M1 BOTH IN 1981, 1982 AND 1983 FOLLOWED SIZEABLE

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INTEREST RATE DECLINES. AT THE SAME TIME THE UPWARD TREND IN M1 QUOTE VELOCITY UNQUOTE MAY BE CHANGING. THE FEDERAL RESERVE'S VIEW IS THAT THEY SIMPLY DO NOT HAVE ENOUGH EXPERIENCE WITH THE NEW INSTITUTIONAL FRAMEWORK SURROUNDING M1 TO SPECIFY WITH ANY PRECISION WHAT NEW TREND IN VELOCITY MAY BE EMERGING OR THE PRECISE NATURE OF RELATIONSHIPS BETWEEN FLUCTUATIONS IN INTEREST RATES AND THE MONEY SUPPLY. THIS EXPLAINS THE (PERHAPS TEMPORARY) DOWN-GRADING OF M1 AS AN INDICATOR.

- THE DECISION TO QUOTE REBASE UNQUOTE THE M1 TARGET ON WHICH VOLCKER REVEALED THAT THERE WERE TWO DISSENTING VOICES ON THE FOMC) TAKES ACCOUNT BOTH OF SOME CHANGE IN TREND VELOCITY AND A RETURN TO INTEREST RATES CLOSER TO LEVELS HISTORICALLY NORMAL. VOLCKER'S NOW WAS THAT REBASING WOULD HAVE LESS EFFECT ON THE MARKETS THAN WOULD HAVE INCREASING THE TARGET RANGE (SEE PARA 4 BELOW).

- VOLCKER EXPRESSED CONCERN ABOUT THE PERSISTENT DEBT CREATION WELL IN EXCESS OF THE GROWTH OF THE ECONOMY AND HISTORICAL EXPERIENCE

AND THEREFORE LOOKED TOWARDS SOME MODERATION IN THAT GROWTH NEXT YEAR. HIS VIEW IS THAT AS LONG AS THE US RUNS MASSIVE BUDGETARY DEFICITS, IT WILL REMAIN DEPENDENT ON UNPRECEDENTED CAPITAL INFLOWS TO HELP FINANCE DIRECTLY OR INDIRECTLY THAT DEFICIT. THE NET CAPITAL INFLOWS WILL BE MIRRORED IN A TRADE DEFICIT - THEY ARE QUOTE SIAMESE TWINS UNQUOTE.

- THERE IS A CRUCIAL NEED TO REDUCE US DEPENDENCE ON FOREIGN CAPITAL AND THE RISING IMPORTS TO MEET DOMESTIC DEMANDS, BY CURTAILING THE BUDGET DEFICIT. THE ADJUSTMENT WOULD BE EASED AS

WELL IF OTHER INDUSTRIALISED COUNTRIES BECAME LESS DEPENDENT ON STIMULUS FROM THE US FOR GROWTH IN THEIR OWN ECONOMIES.

- ALL OF THE INDUSTRIALISED COUNTRIES, WORKING WITH THE IMF, THE WORLD BANK AND BY OTHER MEANS, NEED TO CONTINUE TO SUPPORT THE EFFORTS OF MUCH OF THE DEVELOPING WORLD TO RESTORE THE FINANCIAL AND ECONOMIC FOUNDATIONS FOR GROWTH IN THEIR COUNTRIES.

- MONETARY POLICY MUST BE PART OF THE EFFORT TO CORRECT IMBALANCE IN THE ECONOMY. BUT THE US ALSO NEEDS TO COME TO GRIPS WITH THE BUDGET DEFICIT, AND TO AVOID QUOTE A WITCH'S BREW OF PROTECTIONISM UNQUOTE.

COMMENT

3. THE TESTIMONY WAS WELL RECEIVED BY THE COMMITTEE AND VOLCKER DEALT SKILFULLY WITH THE GENERALLY MUTED AND RATHER UNFOCUSSED QUESTIONING. OUR MAIN IMPRESSIONS ARE AS FOLLOWS:-

- FIRST, A SUBSTANTIAL PORTION OF THE TESTIMONY WAS DEVOTED TO A DISCUSSION OF THE QUOTE STRAINS, IMBALANCES AND DANGERS UNQUOTE IN THE ECONOMY: THERE WAS LESS EMPHASIS THAN ON SOME PREVIOUS OCCASIONS ON COUNTER-INFLATION POLICY - THOUGH, IN RESPONDING TO QUESTIONS, VOLCKER STRESSED SEVERAL TIMES THAT INFLATION WAS STILL TOO HIGH.

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- SECOND, VOLCKER WAS NOTABLY FRANK AND HONEST IN HIS APPRAISAL OF THE CURRENT ECONOMIC AND FINANCIAL UNCERTAINTIES, PARTICULARLY THOSE SURROUNDING THE INTERPRETATION OF M1, WHICH HE REMARKED HAD QUOTE LIMITED USEFULNESS AT PRESENT UNQUOTE.
- THIRD, IT IS STRIKING THAT THE TESTIMONY EXPRESSED PARTICULAR CONCERN ABOUT THE ACCUMULATION OF DEBT AS A FACTOR UNDERLYING (AND PERHAPS ULTIMATELY UNDERMINING) THE ECONOMIC RECOVERY.
- FOURTH, THE TESTIMONY (PREDICTABLY) STRESSED THE RESOLUTION OF THE BUDGET DEFICIT PROBLEM AS THE KEY TO REMOVING MAJOR IMBALANCES FROM THE ECONOMY: THE EMPHASIS ON OTHER DEVELOPED COUNTRIES GENERATING ENOUGH QUOTE HOME GROWN EXPANSION UNQUOTE TO SUPPORT THE WORLD RECOVERY, HOWEVER IS A RELATIVELY NEW DEVELOPMENT IN THE FEDERAL RESERVE'S PUBLIC POSTURE, AND ONE REPEATED SEVERAL TIMES BY VOLCKER IN RESPONSE TO QUESTIONS.

4. IT IS REASSURING THAT THE MARKETS GENERALLY SEEM TO HAVE TAKEN BOTH THE RELEASE OF THE REPORT YESTERDAY AND TODAY'S TESTIMONY IN THEIR STRIDE. THE WIDESPREAD EXPECTATION HAS BEEN THAT THE FEDERAL RESERVE WOULD ADJUST THE RANGES FOR M1, AND MARKETS MAY ALSO HAVE BEEN INFLUENCED (IN DIFFERENT DIRECTIONS) BY RECENT ECONOMIC INDICATORS (INCLUDING TODAY'S FIGURES SHOWING A 0.5 PERCENT RISE IN PERSONAL INCOME IN JUNE) AND BY THE LARGE SECOND QUARTER LOSSES REPORTED BY THE BANK OF AMERICA. SHARE PRICES ROSE BY 9 POINTS DURING THE DAY, REFLECTING THE MARKET'S VIEW THAT MONETARY POLICY WOULD CONTRIBUTE TO STRONGER GROWTH IN THE SECOND HALF OF THE YEAR. BUT THERE WAS LITTLE CHANGE IN INTEREST RATES AND THE DOLLAR FELL AGAINST MOST MAJOR CURRENCIES..

5. FCO PLEASE PASS TO FITCHEW AND MATTHEWS (TREASURY), GREEN (BANK), BROADBENT (EA) AND TAIT (ERD).

(REPEATED AS REQUESTED)

WRIGHT

MONETARY
NAD
MR DAVID THOMAS

COPIES TO:-

MR FITCHEW TREASURY
MR MATTHEWS TREASURY
MR GREEN B/ENGLAND

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