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RECORD OF MEETING BETWEEN THE PRIME MINISTER AND THE CHAIRMAN
OF THE US FEDERAL RESERVE SYSTEM IN WASHINGTON ON FRIDAY
26 JULY 1985 AT 1745

Prime Minister

Mr. Paul Volcker

HM Ambassador Washington

Mr. Charles Powell

The Prime Minister said that she had been worried by Mr. Volcker's recent comment that Europe should encourage domestic growth by stimulating demand. She agreed on the need to get interest rates down but there could be no question of reflating or printing money. Mr. Volcker said that his comments had been aimed at Germany and Japan. He took the view that if the Germans were reducing taxes anyway they could afford to speed it up. If they got a little expansion going, they would be in surplus.

US DEFICIT

The Prime Minister said that if she were an American she would be even more worried than a year ago about the failure to cut the deficit. Mr. Volcker agreed that as time passed the risks from failure to take action increased. He believed that a satisfactory deficit-cutting package could be put together in Congress, but no one wanted to take the blame for cutting spending in sensitive sectors, particularly social security.

The Prime Minister said that she had been concerned by reports that an oil import tax might be introduced. Mr. Volcker said that he was not crazy about the idea. It might be the least painful way to raise a little extra revenue, but it would also cause a bump on the consumer price index which would be worrying. The Prime Minister asked about the effect on Mexico and other oil producers. Mr. Volcker said that there was talk of exempting Mexico. But where would you draw the line?

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INTERNATIONAL DEBT

Mr. Volcker said that Mexico was in acute difficulty as a result of letting its budget get out of control. New measures had just been announced to get back on track. It remained to be seen whether they would be sufficient to restore confidence. On the other hand, Argentina was tackling its problems impressively. A Thatcherite programme had been introduced which aimed at budget balance, price stability and single-figure inflation. There had been zero price increases in July. The currency was being changed. The programme appeared to have been sold internally.

Mr. Volcker continued that he was worried by political restiveness in Latin America about the debt situation. Although the situation of several individual countries had improved, a political climate in favour of repudiating debts was being created. Castro had taken a hand in this and there were fears that the new President of Peru would make a radical inaugural statement and attempt to rally others. He was not saying that there would necessarily be a crisis. But if something went wrong, a lot of Latin American Governments might be tempted to go off in this direction.

AIRCRAFT FOR ARGENTINA

Mr. Volcker said that he had to own up to having had a part in the Argentina request for military aircraft from the United States. In discussion with President Alfonsin some three or four months ago about the economic stabilisation programme, Alfonsin had expressed fears of a military coup and had said that it would help his position greatly if the United States could let him have some military aircraft to keep his airforce content. They need not be fancy ones. The main purpose was political: a gesture of support from the United States at a moment when Argentina faced tough decisions. He had passed on President Alfonsin's request for which he had some sympathy. The Prime Minister said that she hoped the Argentine economy could be stabilised. But it would be

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absolutely devastating if the United States were to sell military aircraft to Argentina particularly while Argentina refused to end the state of hostilities with Britain. Mr. Volcker would have noticed that that we had recently made a helpful gesture to Argentina by lifting the trade embargo but this had not produced any correspondingly helpful response. Mr. Volcker admitted that the Argentines owed Britain something.

BANKING IN THE UNITED STATES

The Prime Minister asked about the health of the banking system in the United States. Mr. Volcker said that as time passed, the situation was improving. In terms of Latin America exposure the US banks were back to where they were in 1978-79. But it was more a question of diluting the problem than solving it: the exposure remained so great that even some reduction in it did not significantly change the risk.

JAPAN

The Prime Minister said that she had once again tackled the Japanese about their surplus and the low rate of the yen at the International Democratic Union's Conference that morning. Mr. Volcker said that he did not expect recent Japanese measures to have any serious effect on the trade surplus. The Japanese did not want to change the situation because they liked it the way it was. On the other hand, he thought that threatening Japan with restrictions on her exports was a very dangerous game. No one knew where it would lead. The Prime Minister commented that this was why we had wanted a new GATT round where all the major industrialised countries could bargain about their problems.

In reply to the Prime Minister's question about the risk of protectionism in the United States, Mr. Volcker said that the same congressional committees responsible for trade legislation were also responsible for tax reform and were giving priority to this. It remained to be seen whether they

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would have time enough to turn their attention to trade legislation. If they did, there would be trouble.

MONETARY POLICY

The Prime Minister said that she had noted that the Federal Reserve was keeping quite a tough monetary policy. Mr. Volcker said that he had let out a little. He had redefined the M1 target. This was sustainable because the United States economy was soft, interest rates were coming down and it did not look as though there was a risk of inflation. But he would not let things get out of control. The danger would come when the dollar fell. He was congenitally concerned that when it fell, it would go in a big way. There was no doubt that an economy with a \$150 billion trade deficit was vulnerable.

The meeting ended at 1830.

C.D.P.

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