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 FM WASHINGTON
 TO DESKRY 130800Z F C O
 TELNO 2577
 OF 122000Z SEPTEMBER 85

MIPT: MINISTER (ECONOMIC'S) MEETING WITH CHAIRMAN VOLCKER m

1. MIPT REPORTS ON MINISTER (ECONOMIC'S) MEETING YESTERDAY WITH VOLCKER. INTERNATIONAL DEBT WAS MAIN TOPIC AS DESCRIBED IN MIPT, BUT VOLCKER TOUCHED BRIEFLY ON THE FOLLOWING AS WELL.
 - (A) VOLCKER NOTED THAT WE ARE PAYING LESS AND LESS ATTENTION TO STERLING M3 AND ASKED WHETHER WE WERE PLANNING TO DROP IT AS A TARGET AGGREGATE. LANKESTER SAID THAT THE RECENT RAPID GROWTH OF STERLING M3 IN EXCESS OF THE TARGET RANGE WAS ONE REASON WHY WE HAD BEEN CAUTIOUS ON INTEREST RATES. ON THE OTHER HAND, IT WAS CLEAR THAT THERE HAD BEEN A DOWNWARD SHIFT IN VELOCITY, HENCE WE WERE TENDING TO DOWN-PLAY STERLING M3'S SIGNIFICANCE AND WERE PAYING MORE ATTENTION TO M0 AND THE EXCHANGE RATE AS INDICATORS OF MONETARY CONDITIONS. BUT WE HAD NO IMMEDIATE INTENTION OF DROPPING STERLING M3 AS A TARGET AGGREGATE. VOLCKER COMMENTED THAT HE COULD SEE NO INTELLECTUAL JUSTIFICATION FOR M0 AS A TARGET AGGREGATE. HE ALSO ASKED IF WE WERE GOING TO JOIN THE EMS, GIVEN THE GREATER ATTENTION BEING PAID TO THE EXCHANGE RATE. LANKESTER SAID THAT M0 WAS THE ONE AGGREGATE SHOWING A REASONABLY STABLE VELOCITY TREND. CONSEQUENTLY WE DID REGARD IT AS A VERY USEFUL INDICATOR. AS REGARDS THE EMS, ALTHOUGH THE ARGUMENTS SEEMED MORE FINELY BALANCED THAN IN THE PAST, THERE WAS NO INTENTION AS OF NOW TO SEEK ENTRY TO THE EXCHANGE RATE MECHANISM.
 - (B) ON THE US ECONOMY, VOLCKER SAID THAT HE WAS CONCERNED ABOUT THE PROSPECT OF 'TOO STRONG' A RECOVERY IN THE FOURTH QUARTER. (AXILROD (FED STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY) TOLD LANKESTER SEPARATELY THAT GROWTH AT AN ANNUAL RATE OF 5 PER CENT IN THE FOURTH QUARTER, THOUGH NOT THE THIRD, NOW SEEMED VERY POSSIBLE IN THE LIGHT OF THE LATEST INDICATORS.) VOLCKER SAID THAT IF THE ECONOMY REBOUNDED TOO FAST, AND GIVEN THE APPALLING FISCAL POSITION, THIS WOULD PUT EXCESSIVE STRAIN ONCE AGAIN ON MONETARY POLICY. HE VIEWED WITH ALARM THE POSSIBLE NEED TO RAISE INTEREST RATES FURTHER. IF INTEREST RATES DID RISE, AND THE DOLLAR FURTHER STRENGTHENED, THIS WOULD MAKE IT MORE DIFFICULT FOR THE ADMINISTRATION TO STAND UP TO THE CURRENT PROTECTIONIST PRESSURES COMING FROM CONGRESS, AND WOULD FURTHER AGGRAVATE THE DEBT PROBLEM.
2. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, FITCHEW AND PERETZ (TREASURY), BRAITHWAITE AND TAIT (FCO), AND LOEHNIS AND GREEN (BANK OF ENGLAND).

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INTERNATIONAL DEBT.

1. MINISTER (ECONOMIC) PAID COURTESY CALL ON VOLCKER YESTERDAY. VOLCKER WENT OUT OF HIS WAY TO STRESS THE SERIOUSNESS OF THE CURRENT DEBT SITUATION IN LATIN AMERICA. HE WAS PARTICULARLY WORRIED ABOUT MEXICO AND BRAZIL. THE MEXICANS WERE WEARYING OF SEVERAL YEARS OF AUSTERITY AND THEIR COMMITMENT TO THE QUOTE SYSTEM UNQUOTE SEEMED ON THE WANE. THE BRAZILIANS HAD DONE WELL TO DATE IN TURNING ROUND THEIR BALANCE OF PAYMENTS WHILE MAINTAINING GROWTH, BUT THE NEW ECONOMIC TEAM LOOKED VERY UNPROMISING. OF THE LARGE DEBTORS, ONLY ARGENTINA SEEMED IN RELATIVELY GOOD SHAPE FOR DEALING WITH ITS DEBT PROBLEM, THOUGH WHETHER ALFONSIN WOULD BE ABLE TO STAY THE COURSE WITH HIS ECONOMIC MEASURES WAS ANOTHER MATTER.

2. VOLCKER ARGUED THAT A NEW QUOTE PUBLIC FRAMEWORK UNQUOTE WAS NEEDED IN WHICH THE IBRD WOULD PLAY THE PIVOTAL ROLE. SOMEHOW THERE HAD TO BE A SUBSTANTIAL INCREASE IN CAPITAL FLOWS. THE IBRD COULD PROVIDE SOME OF THIS INCREASE ITSELF AND COULD BE THE CATALYST FOR INCREASED BANK LENDING. THE IMF DID NOT HAVE THE RESOURCES AND WITH ITS ANTI-GROWTH IMAGE LATIN AMERICA WAS TIRED OF DEALING WITH IT. THE IMF WOULD STILL HAVE A ROLE TO PLAY WITH STABILISATION PROGRAMMES AND PERHAPS IN ENHANCED SURVEILLANCE, BUT IT WOULD HAVE TO ACT IN TANDEM WITH THE IBRD. TO INCREASE ITS OWN LENDING QUICKLY, THE IBRD WOULD NEED TO EXPAND ITS PROGRAMME OF STRUCTURAL ADJUSTMENT LOANS. IT SHOULD INSIST ON TOUGH CONDITIONALITY, COUNTRIES WERE MORE LIKELY TO ACCEPT THIS FROM THE IBRD THAN FROM THE FUND. THE IBRD WOULD NEED TO DRUM UP SUPPORT FOR SALES FROM THE BANKS. PREFERABLY, THE IBRD SHOULD NOT ENGAGE IN GUARANTEES A LA THE RECENT URUGUAY PROPOSAL (SEE UKDEL IMF/IBRD TELNO 162). BUT THIS WAS A SECONDARY ISSUE. THE MAIN QUESTION WAS HOW TO INCREASE THE TOTALITY OF LENDING ON ACCEPTABLE TERMS.

3. VOLCKER SAID THAT A GENERAL CAPITAL INCREASE FOR THE IBRD WOULD CLEARLY BE NECESSARY BUT FOR DOMESTIC POLITICAL REASONS HE WOULD NOT PRESS FOR ONE IN THE NEAR FUTURE. INSTEAD THE IBRD SHOULD TAKE A MORE RELAXED VIEW OF THE SUSTAINABLE LENDING LEVEL AND BE PREPARED, IF NECESSARY, TO HAVE A HUMP IN LENDING COMMITMENTS. VOLCKER DID NOT MENTION A SPECIFIC FIGURE FOR INCREASED IBRD LENDING, BUT HE SEEMED TO HAVE IN MIND AN EXTRA SEVERAL BILLION DOLLARS PER YEAR. HOWEVER, HE STRESSED THE NEED FOR GOOD QUALITY LENDING.

COMMENT.

4. VOLCKER HAS BEEN ARGUING FOR SOME TIME THAT THE IBRD SHOULD BE DOING MORE ON THE DEBT FRONT. ALTHOUGH HIS IDEAS DO NOT SEEM FULLY FLESHED OUT, OUR IMPRESSION (FROM SEPARATE CONVERSATION WITH TRUMAN AT THE FED) IS THAT HE IS PUTTING CONSIDERABLE PRESSURE ON THE ADMINISTRATION TO CONSIDER THEM SERIOUSLY. SHOULD THE ADMINISTRATION DO SO, FOLLOWING MAJOR QUESTIONS WOULD ARISE:

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(A) WOULD IBRD SUPPORT (PARTICULARLY IN THE FORM OF GUARANTEES) IN FACT ENCOURAGE VOLUNTARY BANK LENDING OR MERELY ENCOURAGE BANKS TO DEMAND IBRD SUPPORT IN ALL CASES QUES.

(B) WOULD IT BE COMPATIBLE WITH IBRD'S PRIMARY ROLE OF INVESTMENT FINANCE FOR IT TO ASSUME MAJOR ROLE IN BALANCE OF PAYMENTS FINANCE QUES.

(C) DOES IBRD HAVE TECHNICAL AND MANAGEMENT CAPACITY TO PRESCRIBE AND ENFORCE CONDITIONALITY AND CARRY WEIGHT WITH COMMERCIAL BANKS QUES. CERTAINLY IMF SEEMS BOUND TO REMAIN A KEY PLAYER DESPITE ITS RELATIVE LACK OF RESOURCES AND POOR IMAGE.

(D) WHAT ARE IMPLICATIONS OF EXPANDING IBRD LENDING TO HEAVILY INDERTED COUNTRIES FOR IBRD'S OWN FUTURE FINANCIAL HEALTH QUES.

(E) CAN ONE CREDIBLY ARGUE FOR A LARGER IBRD ROLE IF US STILL HESITATE TO ACCEPT NEED FOR A CAPITAL INCREASE- OR IF ROLE WILL REQUIRE SIZEABLE PAID IN PORTION OF ANY SUCH INCREASE QUES.

5. WE HAVE NO REAL FURTHER INFORMATION ON THE TREASURY'S RE-APPRAISAL OF DEBT POLICY ISSUES (SEE WASHINGTON TELNO 2462). ONE IDEA WHICH SEEMED TO BE GAINING GROUND WAS THAT THERE SHOULD BE A LARGE INCREASE IN IBRD GUARANTEES. BUT DALLARA (TREASURY DEPUTY ASSISTANT SECRETARY, INTERNATIONAL MONETARY AFFAIRS AND FUNDED) TOLD UKDEL THAT US HAS BEEN IMPRESSED BY ARGUMENTS PUT FORWARD BY THE UK AGAINST SUCH GUARANTEES. IN GENERAL, HE HAS CAUTIONED AGAINST OUR GETTING THE IMPRESSION THAT THE US IS ABOUT TO MAKE ANY MAJOR CHANGE IN POLICY.

6. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, FITCHEW AND PERETZ (TREASURY), BRAITHWAITE AND TAIT (FCO), AND LOEHNIS AND GREEN (BANK OF ENGLAND).

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