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NOTE FOR THE RECORD

MEETING WITH SIR ALAN WALTERS

The Prime Minister today met Sir Alan Walters for about three quarters of an hour.

Sir Alan said he thought policy was if anything a little tight, rather than loose. The yield curve was downward sloping, which suggested that people expected interest rates to fall. There was considerable buoyancy of consumer demand, and the CBI and IOD surveys suggested that confidence was reasonably stable. He saw no reason for a decline in output next year and he thought that output could rise by 3 per cent or even a little more.

The monetary base was growing on average at about 5 per cent and had been for many years. This suggested that inflation itself might continue to run at about 5 per cent, though with variations around that level. The number of small firms was growing well, and productivity seemed likely to increase by 4 per cent or so which was good, though probably not as high as the outstanding rates of 6 per cent or more which had been achieved in the past few years. The UK had had an investment boom. New jobs were being created at a rapid rate, and vacancies were rising strongly. The savings ratio was quite high. There would probably be some tailing off in investment, but the prospects in general seemed good. The main concern must be over the rate of increase in wages.

There were risks, of course, including particularly those arising from the United States. US interest rates at the short end had begun to creep back up a little. The US dollar had fallen, but the high yield on investments in dollars and the demand for world savings arising from the budget deficit meant that there was still a strong possibility that the US dollar could rise again.

Sir Alan outlined the prospects for the Congressional Bill to produce year by year reductions in the budget deficit. It seemed likely that something would be passed, though interested Congressmen were as always using it as an excuse to tack on their own pet proposals.

Sir Alan explained his concerns that if the Government began to slip in the opinion polls during the course of 1986, there could be an outflow of capital which could gather momentum as people tried to beat the rush ahead of an election. The right response would not be to raise interest rates, but to allow sterling to find its own level. The problems of an outflow of capital would be immensely increased if sterling were in the EMS, since the main immediate option then would be to hike interest rates. Fiscal policy might also need to be used. To take sterling out of the EMS or to devalue would both be unattractive options. Sir Alan noted that legislation allowing the re-introduction of exchange controls was still on the statute book and there could be pressure for the controls to be reimposed. Only the Dutch, with the Germans, in the EMS had open capital markets.

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DAVID NORGROVE

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