cc Alan Walters
A Duguid
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see by MS
see letter 12/10

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PRIME MINISTER

The current economic instability in the Western world has its origins in the United States. On my recent visit there I talked to all the key figures. The following are my considered reactions.

2. The United States is trying simultaneously to complete its adjustment to the two oil shocks; to increase defence spending sharply; and to make a major reduction in the inflation which has rooted itself deeply in its economy; and at least to reduce, and eventually eliminate, deficit spending. Success by the US would benefit all of us. At present however the strains of this multiple effort are transmitting themselves to other countries via interest rates and exchange rates, for the dollar remains the principal reserve and trading currency (including the currency of oil) and the principal financial markets are dollar markets.

3. The root of the problem is that US Administration has not yet convinced markets in the US that its anti-inflation programme will succeed. It has not yet convinced them that it can control and eliminate the budget deficit as far and as fast as necessary. As a result US interest rates remain very high (prime rate 19 per cent; 3 month money 15-15½ per cent; government long bonds 15 per cent; with an inflation rate of 11 per cent in consumer prices). The President's targets have been a budget deficit of $43 billion in fiscal year 1982, reducing to nil by 1984. After enacting a major expenditure cutting programme in the summer, he put forward further proposals on 24 September for additional savings of $16 billion, in order to get back on target for 1982 but it is not at all

certain that he will get his way. Furthermore, the markets, and the US bankers with whom I spoke, clearly feel that the Administration is not sufficiently single-minded about reducing the deficit it has to finance. They note that the Administration has not found it possible to make economies in indexed social security pensions; or to scale back significantly its planned increase in defence expenditure; or to forgo tax reductions; or to increase indirect taxes.

4. US interest rates may well remain high (and volatile) until there is a more convincing picture on the deficit, promising a reduction in US government borrowing and a substantial fall in the inflation rate. A weakening dollar could delay any fall in the rates.

5. None of this means that we should fail to support President Reagan's efforts to beat inflation. There are great and continuing risks to the world economy if he fails. They do mean however that in private we should continue to urge on him and his US government colleagues the need to control the US budget deficit. Some - e.g. Stockman - need no urging, but the President's position is ambivalent. He seems anxious to avoid fiscal action in advance of the 1982 congressional elections, and it is not yet clear that control of the deficit is the objective to which he attaches the highest priority - as for Europe's sake it should be.

6. For we face a harsh environment so long as we are exposed to high US interest rates. Fortunately British industry has had the benefit of a better wage round, of improvements in productivity, and of interest rates below those in the United States. Interest rates would have gone up much sooner, and now be much higher, but for the action we took at the time of the Budget.

7. But this environment makes it all the more necessary for us to avoid getting out of line, and pursuing policies softer than those adopted by other countries, as we did in 1974-76. The UK is still particularly exposed to international monetary and trading developments. It is more than ever necessary that we should strictly control our PSBR and our monetary framework if we are to come through safely.

8. This is the lesson Chancellor Schmidt drew from the prospect of continuing high US interest rates after the Ottawa Summit. He returned home to organise budgetary savings. The French did the opposite. The latest US developments suggest that Chancellor Schmidt was right. The French have been forced to devalue and are now using the latest US signals, in and at the time of the IMF meetings, as the reason - or excuse - to prune back their budgetary growth.

9. In Opposition we took the view that the policies of restraint which the IMF urged on the Labour Government were right. In his address to the recent Meetings, the Managing Director of the IMF emphasised to member countries that it was "essential not to relax the efforts to combat inflation". Colleagues may be interested to see the attached extract from his speech.

10. The IMF prescription, now as in 1976, is in line with our own. I am clear that we must continue to follow it.

11. Copies of this minute go to Cabinet colleagues, and to Sir Robert Armstrong.

G.H.

(G.H.)

8 October, 1981

EXTRACT FROM STATEMENT BY J. DE LAROSIERE, CHAIRMAN OF THE EXECUTIVE BOARD AND MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND IN PRESENTING THE THIRTY-SIXTH ANNUAL REPORT OF THE EXECUTIVE DIRECTORS TO THE BOARD OF GOVERNORS OF THE FUND

"At this stage in our progress, it is essential not to relax the efforts to combat inflation, but rather to press on with determination. Experience has amply demonstrated that sustained, sound growth requires that inflation first be brought under control. In some conditions, it is possible to increase economic activity temporarily through demand-stimulating policies. But an economy in the grip of inflation cannot be permanently revived by printing more money. The need today is to enable our economies to produce more, and at less cost.

The policy effort must be intensified along two basic lines: more effective demand management and measures to improve supply.

Let us look at demand management first. I observed a moment ago that the industrial countries have the growth of their monetary aggregates under better control today. Nevertheless, the burden being placed on monetary policy is undoubtedly excessive. To be effective, monetary policy must be supported by a coherent, sound fiscal policy. But it is evident that the fiscal policies of a number of industrial countries have been excessively expansionary since the early 1970s. The combined budget deficit of the industrial countries is about twice as large, in terms of GNP, as it was in 1973. A third of the industrial countries recorded a budgetary surplus in 1973; all of them are in deficit today. This weakness in public finance has stimulated demand-pull inflation and reduced the share of financing available to the private sector.

It is not possible to generalize in this area, of course, since the effects of a budget deficit can be assessed only in the context of the particular economy concerned. But it is certain that when credit demand is still strong, and the rate of saving is inadequate, a budget deficit, even if relatively moderate, can intensify competition among borrowers and push interest rates upward. I might add that, beyond these direct economic effects, fiscal management is often rightly seen by the public as a test of a government's seriousness and determination in fighting inflation.

In view of the importance of the US economy and the effects of US policy on the rest of the world, a few words on the United States are in order at this point. From an international standpoint, the sharp increase of US interest rates and - at least until recently - their great volatility, as well as the dollar's appreciation on the exchange markets, have become the subject of much controversy. These developments have had repercussions on many other countries, and in some cases have given rise to policy dilemmas. In the United States itself, the persistence of high interest rates has become a source of widespread dissatisfaction and disappointment. Whatever the criticisms and pressures in this area, however, I think it would be a great mistake to surrender to them by raising the monetary targets. Reduction of the rate of US inflation is crucial to world economic stability; it must be achieved, and it can only be achieved if monetary policy holds firmly to its course and is consistently applied. The effort thus far to combat inflation has been encouraging, monetary targets have been set, and deep budget cuts have been made. The fact remains, however, that a decisive and sustained effort to reduce the budget deficit is necessary if inflationary expectations are to be broken and the pressure of government demands on the financial markets are to be eased.

But, vital as it may be, the control of overall demand cannot by itself eliminate inflation. The causes of inflation are rooted in our societies, and stem from a multitude of habits, attitudes, and rigidities which also demand remedy and correction. This is a long-range task, to be moulded in each case by the characteristics and policies of the country concerned. But, however different the situations, the necessary structural reforms all hinge on a few simple ideas. Incentives to work and save must be strengthened. Unnecessary, paralysing regulations must be abolished. Flexibility, a capacity to react, and a willingness to take risks - characteristics which too often have given way to rigidity, protection and privilege - must be restored to our economies. There are no magic responses to the challenges we face; rather, we must persevere in a combination of convergent, consistently applied measures.

The analysis I have just made may appear conservative to some. But I believe it is wholly realistic. It is true that unemployment is reaching alarming levels. Who could underestimate the importance of this problem? Yet it seems certain that we can never hope to solve it by weak financial management. On the contrary, the unemployment problem was exacerbated by the inflationary policies of the years 1973 to 1979. Productive investment, the basis of all growth, can be revived not by distributing additional means of payment, but by strengthening investor confidence in the health of the economy. This, in turn, requires monetary stability above all; it is the prerequisite for increased saving. This leads me to state forcefully, as the Executive Board asked me to do a few weeks ago, that the fight against inflation must be waged courageously and with determination. This is undeniably a priority if the unemployment problem is to be attacked with any chance of lasting success.

Premature relaxation of the restraints on demand in countries experiencing severe inflation would only aggravate the inflation, jeopardise the currency, and hamper growth. Perseverance is therefore required in the struggle against inflation. In the present social environment, this calls for difficult decisions; in the short term, in fact, they will probably aggravate the economic slowdown. But they are vital if we are to overcome the stagflation that has characterised the industrial economies for too long."

29 September 1981

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VLB

FILE

cc: Mr Walters
Vereker
Hoskyns

12 October 1981

In Stats file

Building Societites Mortgage Interest Rate

The Prime Minister has seen and noted the Chancellor's minute of 8 October.

I am sending a copy of this letter to David Wright (Cabinet Office).

MICHAEL SCHOLAR

John Kerr, Esq.,
H.M. Treasury.

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