NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE US TREASURY
FRIDAY 19 NOVEMBER 1982 AT 4.00PM

Present:

Mr Beryl Sprinkel, Under Secretary for Monetary Affairs
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

Monetary Policy

1. Mr Sprinkel said that he was most concerned at the irregular growth of M1. For example, there had been a sharp squeese on M1 during 1981. The Treasury would much have preferred to have had a gradual reduction which would in turn have had a less adverse effect on the real economy. The irregularity primarily resulted from 2 factors. First the Fed did not try very hard to counter short run movements in the aggregates because it honestly believed fluctuations over a 6 month period did not matter (perhaps because most of these reflected movements in money demand). Second, the Fed had a very loose mechanism for controlling growth in the aggregates. In particular its lagged reserve accounting procedures, which are not now due to change until the Spring of 1984, meant that, in a sense, money determined reserves rather than the other way around. Also its practice of making infrequent discount rate changes created distortions between borrowed and non-borrowed reserves. The Fed is not likely to change these procedures until there is a new Chairman.

2. Professor Walters asked whether the recent spike in M1 was due to the maturing of all-saver certificates. Mr Sprinkel said that he might believe this explanation except that the monetary base and reserves were also rising rapidly at the present time. He therefore suspected that this was not the only or main explanation.

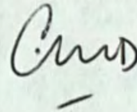
Interest Rate Volatility

3. The Treasury is putting final touches to a study which shows that volatility in the growth of M1 had raised interest rates by 2-3% on average. (The report is to be published soon.) The Fed, who initially dismissed this conclusion, have come around to the view that higher volatility might increase interest rates by 1%. Another reason for high US interest rates was that markets simply did not believe the President's budget estimates.

Independence of the Fed

4. A paper had just gone to Secretary Regan on the future structure of the Federal Reserve Board. Mr Sprinkel said he had recommended that it remain independent, mainly because any attempt to bring it into the Administration would involve a difficult fight and the outcome could not be reliably predicted. It was however possible to make some changes to improve the Fed's effectiveness, eg the President should be able

to appoint his own Chairman when he enters office. Congress is now considering legislation that would constrain monetary policy by forcing the Fed to target on interest rates.



20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 3PM ON FRIDAY 19 NOVEMBER 1982

Present:

Mr Paul Volcker, Chairman, Federal Reserve Board
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

The Monetary Aggregates

1. Mr Volcker said that it was becoming increasingly difficult to interpret the monetary aggregates. One could rationalise why the aggregates were growing so rapidly and accept in principle that some of this growth sould be accommodated. The main problem was estimating precisely what adjustment to make. Moreover, if this were possible, the financial markets tended not to believe you if you said there were good reasons for accommodating some of the growth.

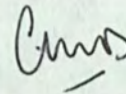
2. Mr Volcker said that the Fed had in the past set the path for non-borrowed reserves primarily with reference to the M1 target. The Fed was now giving more weight to M2 and to a limited extent M3. The changes taking place in the demand for money were clearly dramatic: M1 velocity was going to drop this year for the first time since the War and M2 velocity is expected to decline by a record amount. There were many factors responsible for these changes including the decline in interest rates and an increase in liquidity preference. It would not be possible to go back to setting the path of non-borrowed reserves in the basis of M1 for about a year.

3. Professor Walters responded that the UK had had a similar experience in 1980. The monetary aggregate Sterling M3 was growing very rapidly whilst other indicators pointed to monetary tightness eg the high foreign exchange rate, high interest rates and the low growth in the monetary base and M1. Mr Volcker agreed that the Fed's recent procedural changes were in some ways analogous to the 1980 situation in the UK. If M2, now only just above its target range, came down a bit, it would greatly help the Fed. The Fed had a difficult problem: it wanted to keep interest rates coming down but did not wish to indicate to the markets that this was to the detriment of its overall strategy.

International Situation

4. Professor Walters was particularly concerned about the German economy. Manufacturing output had declined 6.8% in the 2nd Quarter of 1982 and unemployment was now rising very rapidly. It was difficult to see how the German economy would pull out of recession any time soon since major structural problems remain eg in the chemical and steel industries.

5. Mr Volcker said that he was currently spending a great deal of time on the Mexican debt situation. Mexico would need further new money at the end of this year. It was going to be very difficult to bring the 1600 or so banks involved on board by that time. Argentina also presented a serious problem though in many ways its economy was in much better shape than Mexico's. It would however be a messy business. Brazil was also a real problem. His objective was to hold off addressing the Brazilian problem until Mexico was well on the way to being dealt with, so that they were not both in the headlines together.



20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE US TREASURY ON THURSDAY 18 NOVEMBER 1982 AT 2PM.

Present:

Mr Don Regan, Secretary US Treasury
Mr Beryl Sprinkel, US Treasury
Mr Marc Leland, US Treasury
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

International Criticism of US Policies

1. Secretary Regan said that the US had done everything asked of it at recent economic summits. It had been asked at Ottawa to get inflation under control, and it had. It had been asked at Versailles to get interest rates down, and it had. Now, the US was being told to get its deficits under control. He was not sure how reducing the US deficit would help get the world economy out of recession, indeed it might make matters worse.

2. Secretary Regan asked why the US budget deficit was a problem for Europe and noted that the Japanese budget deficit expressed as a percentage of GNP was larger. Professor Walters said there were a number of reasons. First, the US deficit was in fact larger than the estimates currently quoted because of the off-budget items. Second, it was not so much the size of the budget deficit that was important but the need to ensure that it was trending downwards. For example, in the UK the decision to raise taxes in order to reduce the deficit in the 1981 budget had had a very good effect on UK financial markets. Evidence for this included the relatively flat yield curves on UK government securities and the fact that UK interest rates had been lower than US rates over the last year, in spite of the UK's higher inflation rate. The reason that it was important to convince the market that there would be a downward trend in the budget deficit was the risk that the monetary authorities would monetise the debt (either during the current Administration or future Administrations). In 1981 the UK Government had adopted a restricitve budget in order to reduce the budget deficit. Some 364 economists had subsequently signed an open letter claiming that this budget would cause the economy to go deeper into recession. In fact the recovery virtually started from that point.

Fiscal Policy

3. Secretary Regan said that unemployment was now the most serious problem for Congress. If the private sector did not show signs of early recovery then Congress would act to stimulate activity through the public sector. Congress was in no mood to raise taxes in a recession. The Administration, for its part, would not raise income taxes, though it might increase the gasoline tax and some other indirect taxes

which were user fees. The net result was that it would not be possible to do much this year to reduce the deficit, but the Administration would act to reduce it after the recovery got under way. Professor Walters noted that the UK Government still held a 10 point lead in the polls in spite of high unemployment. This was not just a result of the Falklands conflict.

4. Secretary Regan said that the President's budget for FY84 would show the deficit declining over the next few years. For FY83 the deficit was forecast at $150-$160bn, declining to $130bn in FY84 and to less than $75bn in FY87. These estimates included proposed policy changes and was based on very modest increases in real GNP (about 3-4% annually). They were also consistent with slow growth in the monetary aggregates. Professor Walters said that the UK experience showed that credible budget estimates that included a declining trend in the deficit could have very beneficial effects on financial markets and lead to lower interest rates.

Monetary Policy

5. Secretary Regan said that the political realities of the current situation were that if interest rates did not come down within the next two months "the Fed would no longer exist in its current form". This was Congressional reality rather than an Administration position. Most Congressmen who had supported the Fed's tight monetary policy had lost in the November elections and both left and right were determined to get interest rates down. At present the opponents of the Fed's policy were not well organised. The Fed was being told of this now. The Fed will therefore by trying to operate within its policy to get interest rates down, though it was not clear whether this would result in a small or large interest rate reduction.

Protectionism

6. Secretary Regan said that protectionism was becoming a big issue in domestic US politics. There was a lot of pressure for a move in this direction. He felt that the US was not getting much help from its EC partners in its objectives for the upcoming GATT Ministerial. Professor Walters said that the UK also wanted to prevent a move towards protectionism. Nonetheless it was concerned at some of the disparities in tariff rates eg in trade between Spain and the UK in cars. Secretary Regan said that the US was similarly disadvantaged in its car trade with Japan through their use of import regulations.

Conclusion

7. Secretary Regan said that he wished to leave with Professor Walters the message that the Administration was mindful of the size of US budget deficits and was attempting to keep them under control. With an anaemic economy it would be difficult to make rapid progress but the Administration intended to keep up the fight.

20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE AMERICAN ENTERPRISE INSTITUTE, 11.45AM, THURSDAY 18 NOVEMBER 1982

Present:

Dr T Johnson, Director of Economic Studies, AEI
Dr H Stein, AEI, + Guest (Israeli Central Bank)
Dr W Fellner, AEI
Dr A Broida, AEI
Dr M Foss, AEI
Dr J Weicker, AEI
Professor A Walters, No 10
Dr M Dadd, British Embassy

The Disinflationary Process

1. Dr Fellner asked whether, in Western countries, the disinflationary process took 4-5 years to work its was through the economy. Professor Walters replied that it would take at least 4 years for the necessary structural adjustment to take place. One had to remember real interest rates had been negative for some 15 years and real wages in many industries and groups of workers had got out of line. It was bound to take time.

Unemployment

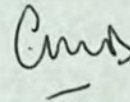
2. The increase in UK unemployment was not simply the result of the recession. Another problem was that as real wages were going down, unemployment benefits were rising with inflation, thereby compressing the income differential between those in and out of work. Indeed, in the UK, 1½m of the unemployed were receiving more than 85% of the income that they would receive in work. Another problem was that UK unemployment benefits remained at the same level indefinitely, whereas French and German benefits, for example, dropped sharply after a certain period of time increasing the incentive to return to work. Professor Walters noted that it was surprising how many professional economists believed that unemployment was unrelated to the real wage.

3. Dr Stein estimated the natural rate of unemployment in the US to be between 6% and 6½%. Professor Walters noted that estimates of the natural unemployment rate in the UK had risen from ½-3/4m in the 1970s to 1½m now. Dr Weicker commented that he was not sure whether this represented a change in the natural rate or merely a perception of the natural rate. Professor Walters said that there were particular problems posed by high unemployment amongst young people. Employers were increasingly reluctant to take on young people who had been unemployed for an extended period. The problem of youth unemployemt was also more politically sensitive. The key issue was that wages of young people were too high relative to more experienced and therefore more productive workers. Dr Fellner asked whether the UK Government had attempted to get across the message that the unemployment rate did not truly reflect the number of unemployed. Professor Walters replied that it had not.

The Banking System

4. Professor Walters said that a lot of change was taking place in the UK financial system. For example the widespread corporate practice of purchasing the paper of other corporations was diminishing. These funds were increasingly being routed through the banking system. Banks had also entered the residential mortgage business. Dr Stein said the US financial system was also experiencing institutional change though the net trend seemed to be towards dis-intermediation ie business formerly conducted in the banking system was now increasingly being done elsewhere. Professor Walters noted that British banks were in not too bad shape: they had a much higher capital base in relation to liabilities and a somewhat better spread amongst countries than US banks.

5. Professor Walters thought there was unlikely to be a collapse of bank liquidity - partly because of the central bank agreements following the 1974 banking crisis. He recognised however that the current agreement may not be water-tight, for example in the Ambrosario affair. The Italian Central Bank had not supported Ambrosario's Luxembourg branch as many bankers initially assumed it would. Dr Broida said that he believed there was a role for a new international monetary agency, not unlike the IMF, to take over some of the sovereign loans now held by commercial banks and to issue its own debt instruments. Professor Walters said that the IMF was certainly not suited for such a role in its current form. Indeed, he believed that a convincing intellectual case had not been made for increasing the IMF quotas.



20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 9.40AM ON THURSDAY 18 NOVEMBER 1982

Present:

Mr Stephen Axilrod, Staff Director for Monetary Policy, Fed
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

Recent Developments

1. Mr Axilrod said that there had been substantial drops in velocity in both M1 and M2 over the last year. The reduction in M2 velocity was more spectacular since historically it had been more stable. The reduction in short term interest rates was partly responsible for this but even if the interest rate effect was removed one would still have seen a reduction in velocity. This was because, in technical terms, the IS curve had shifted backwards as private sector confidence and spending collapsed. This had not been fully offset by increases in government purchases, even though the budget deficit had increased some $30bn between the first and second halves of 1982 on a high employment basis. In sum, the US experience was that an expansionary fiscal policy combined with a tight monetary policy had adverse implications for the financial markets which in turn held down consumer and business confidence. It had made the recession worse than otherwise would have been the case. Personally he would prefer to have seen a tighter fiscal policy and a weaker monetary policy. This would help the financial sector, confidence, and encourage investment and consumer purchases. Unfortunately US policy was not headed this way.

Changes in Fed Procedure

2. Mr Axilrod said that in October the Fed had started calculating the non-borrowed reserves path that it uses for operational purposes on the growth of M2 rather than on M1. This was because M1 had been growing very rapidly and unpredictably in recent months. In October the increase was particularly rapid, due to the large number of all-saver certificates maturing (this accounted for perhaps a half of the October increase). Moreover, the Fed recognised that it did not know what the effects of various other technical changes were going to be over the next month or two, eg the introduction of a new money market type fund at banks and thrifts. Unfortunately M2 was a "mushy" aggregate. It was insensitive to short-run economic changes and the demand for it with respect to interest rates was inelastic. In spite of its undesirable characteristics, it was uncertain when it might be possible to return to setting the non-borrowed reserves path with reference to M1.

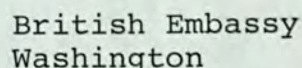
3. It was not clear that this change should be interpreted as an easing of monetary policy. The decision to reduce the discount rate at the last FOMC meeting had been in response to earlier movements in market interest rates. There had been no change since in the discount rate. In other words, there had been no abandonment of monetary targetting or of policy since the October FOMC meeting.

The Outlook

4. The Fed's current forecast was for there to be no significant recovery until late 1983. There had already been a sharp reduction in investment. The inventory reduction was probably still not yet over, given recent declines in industrial production. The only strong signs were in construction and defence and perhaps the wealth effects of the recent stock market rise and improvements in household liquidity. Professor Walters pointed out that lower tangible asset values, particularly in housing, would offset some of the wealth effect in household financial assets.

5. Since confidence in the economy was very poor, real interest rates would have to go lower before the recovery could get under way. Reducing taxes, the approach proposed by some, would probably not work in practice because the beneficial effects on aggregate demand would be more than offset by an adverse financial market reaction and lower confidence. Professor Walters noted that the UK Government introduced a restrictive 1981 budget that many believed would make the recession worse. In practice, however, it was followed by recovery (at least until UK interest rates rose later in the year in response to the rise in US rates). Mr Axilrod noted that recent proposals to bring forward the US July tax cut might lead to higher interest rates and the postponement of the recovery. For the Fed, the big dilema in the coming months was whether it should relax monetary policy to help the economy or hold with the targets adjusted for some of these special factors.

6. Professor Walters noted that this recession was substantially unlike previous ones since the War. Over the last 15 years real interest rates had been negative whereas they were now positive. Real wages had also had to adjust. This was bound to take time. Economists were tending to look at the US position in cyclical terms but there was in fact a lot of structural adjustment going on. Mr Axilrod said that there had already been some progress in the US. Wage costs were now rising at about 6.0% annually and with productivity growing at about 1.0% pa, prices next year might only be rising at 5%. Presuming a faster cyclical rebound of 2-3% in labour productivity, one might even get price increases in the order of 3% next year.



19 November 1982

British Embassy
Washington

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 9.00AM ON THURSDAY 18 NOVEMBER 1982

Present:

Mr Dave Lindsey, Associate Director of Research, Fed
Mr David Howard, International Economist, Fed
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

The Demand for Money

1. Mr Lindsey said that there had been an increase in the demand for M1 in 1982 as inflation declined but the econometric equations had underpredicted its extent. There was evidence of a higher precautionary demand for liquidity than they had earlier expected. This was particularly manifest in the first quarter of 1982 but this effect had clearly carried on after that period. Some had also been associated with the introduction of "NOW" accounts and some with the reduction in interest rates. He nonetheless thought that not all the effect of lower interest rates had yet come through on the aggregates. Professor Walters said that there were many similarities with the UK experience. There had been substantial change in UK money velocity as a result of the sharp reduction in inflation. Retail prices had hardly moved at all over the last few months and there were some further good figures in the pipeline.

Recent Changes in Fed Procedure

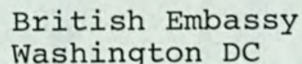
2. Mr Lindsey noted that Mr Volcker had announced at Hot Springs on 9 October that the Fed would be giving less emphasis for the time being to the monetary aggregate M1 and more to M2 (and to some extend M3). In practice, this meant that the Fed was now targetting its non-borrowed reserves path on M2 rather than on M1. (It was not clear at this stage when or even whether the Fed would be able to go back to targetting on M1). Volcker had mentioned 2 reasons for making this change. First, many all-saver certificates were maturing and these funds were being placed in transactions accounts included in M1, which had increased sharply in October. There had been a lot of uncertainty about the extent of this effect at the October FOMC meeting. Second, a new account at banks and thrift institutions similar to money market mutual fund accounts was to be introduced on 14 December. This was likely to cause further distortions. Draft regulations for these accounts called for a $2500 minimum average balance, and a maximum of 3 automatic transfers and 3 cheques a month. No cheque size limitations and no limit on telephone transfers had been proposed. The account therefore had properties of both transactions and savings balances and was logically somewhere between M1 and M2. The Fed

had not made any decision on how to incorporate this account into the aggregates. Nor was it clear how soon a more stable relationship would re-emerge between the aggregates and nominal GNP. The eventual relationship would depend on how banks priced this new account and how the reserve requirements were set.

The Recovery

3. Mr Lindsey noted that many economists were concerned that the recent reduction in interest rates had not been sufficient to get the recovery going. Indeed the Fed staff currently forecast no recovery until the second half of 1983. The business forecasters he had talked to recently had become much more pessimistic about the real outlook. Professor Walters noted that forecasters performance had been very poor over the last few years. For example, in the UK most private forecasters had predicted the result of the 1981 budget would be a further decline in activity whereas the economy had in fact grown somewhat.

4. Mr Lindsey said that, in his view, an acceleration of monetary growth from current levels was not inconsistent with a further decline in inflation over the next couple of years. This was because the structural changes now taking place were increasing the amount of money demanded. Moreover, the current rate of unemployment was well above the natural rate (some 6½%). In other words, if one was disposed to attempt to fine tune monetary policy, this was the time for doing so. Mr Lindsey noted that if there were to be a strong recovery there would still be time to retighten monetary policy before inflation was rekindled.



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