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ALAN WALTERS

PRIME MINISTER

Prime Minister

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UNITED STATES ECONOMIC POLICY

Interpretation

From all my interviews and discussions, the predominant feeling was one of uncertainty, loss of confidence, confusion and flux. Except for the strictly technical people, all those with political appointments were anxious to keep their options open. I attribute this largely to the palpable change in the political atmosphere and alignment.

The elections, although giving rise to the result which was broadly expected, have opened up seams of doubt and they have exposed a hitherto latent dissatisfaction with the policy, so that those who were firm adherents are now to be counted as suspect supporters or even back-sliders. Although the ostensible complexion of the Senate has not changed, the political realities have. And the change in the House is far more significant than the switch of 26 seats.

Monetary Policy

There has, undoubtedly, been a change in the stance of the Fed. To some extent the change is justified by the transformations in the institutions of the banking system. The aggregate M1 has become distorted and the Fed are now targeting on M2. But behind this technical facade there are a large number of opportunities for surreptitious changes.

In my judgement, there has been a considerable easing of monetary policy in the last month or two. The Fed has been blamed by the populists in Congress, who always become more vociferous during the last two years of an administration, and by many of the President's supporters. But apart from the political pressure, there is also the genuine belief that the recovery is so stymied that a small monetary push would do little harm, and might offset some of the political criticism (see interviews with Secretary Regan, Chairman Volcker and David Lindsey).

/If the Fed

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If the Fed is thinking along these lines, and I believe there is considerable evidence that it is, then the expansion must be taken back, preferably gradually, during the course of next year in order to deliver a feasible non-inflationary policy.

There is some evidence that the markets may believe that Volcker has such a policy in train. Long term interest rates have behaved quite well in the last two months. There has been no obvious outburst of inflationary expectations, in spite of more and more gloomy news on the budget front.

There is good reason, however, to fear that Volcker may not be able to draw in the expansion of the latter part of 1982. Pressures can be brought on the Fed to keep it going. I think that Volcker will do everything in his power to resist such pressures, but I am not sure that he will win. If he does not, then it is difficult to see how the United States can avoid drifting up to an 8%-10% rate of inflation once again.

The Budget Deficit

None of this policy for stability will be helped by the burgeoning budget deficit. There are no immediate plans that have a hope of reducing it to a non-inflationary size in the years ahead.

However, I did detect a marked shift in the Treasury, in the person of the Under Secretary, Beryl Sprinkel. He admitted that he was changing his mind about the need for a considerable and obvious reduction in the budget deficit - mainly for psychological reasons. This is a marked change, and since Sprinkel is the main brains behind the Treasury Department, it is quite significant. Secretary Donald Regan merely huffed and puffed and went through well-known defensive strategies to suggest that the US budget deficit was not large, no larger than the Japanese or ours, etc. He clearly displayed some of the pressure he was feeling.

All this is promising, but we have yet to see any concrete measures. The proposal to advance the tax cut six months is ludicrous and quite inconsistent with reducing the budget deficit. It is fine tuning of a clumsy, Keynesian kind.

/In my view

In my view, there will be no firm policy initiative until the President is convinced. Both Sprinkel and Martin Feldstein, the Chairman of the Council of Economic Advisers, suggested to me that you were the only person who could convince the President of the desperate need of the world for a reduction in their future budget deficits.

The Effect On Us

Although all is in a state of flux in the United States, the range of feasible policies that are likely to emerge should not inhibit our policy to any great extent. Provided we do not attempt to peg the dollar exchange rate, we can easily accommodate to a somewhat more expansionary policy by the United States. In the short run it may well be of some assistance to us, in the run up to the election.

In the long run, if Volcker substantially reverses his policy, and the United States inflates at around 10%, then we shall find ourselves in a position similar to that of Germany and Switzerland during the great American inflation of 1978/79. However, I think we have learned enough to deal with that situation if it arises.

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