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ECONOMIC SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

M C Scholar Esq
10 Downing Street
Whitehall
LONDON

5 September 1983

Dear Michael,

The Prime Minister may be interested in the attached notes on the series of meetings the Economic Secretary had in Washington and New York at the end of July. I apologise for not letting you have this before now.

I am sending a copy of this letter and the enclosure to Brian Fall (FCO).

Yours sincerely,

Andrew Hudson

A P HUDSON

CONFIDENTIAL

NOTE OF MEETING WITH DR MARTIN FELDSTEIN

Tuesday 26 July, at 10.00 am

Present

Dr Martin Feldstein, Chairman, Council of Economic Advisers

Economic Secrerary
Mr Wicks
Mr Hudson

1. The Economic Secretary began by explaining the purpose of his visit to the USA. US economic prospects had a major influence on the decisions which he and his Treasury colleagues would have to take over the coming months. He was concerned about the potential impact on the UK economy of the high American budget deficit and of a possible rise in interest rates, and wanted to explore the economic outlook at first hand.

2. Dr Feldstein said that he agreed with the general view that the high deficit had a serious impact on the rest of the US economy. He noted that Congress was beginning to see sense on spending levels, and thought this might make it possible for an agreement on the approach to controlling future deficits to be reached by the end of 1983. If this could be done, it would be important to convey to the markets that there was an agreed approach between the Administration and Congress, even if there was no action until 1985.

3. The Economic Secretary explained the way in which the decision to de-index certain benefits and to raise indirect taxes in the spring of 1981 had been crucial, in political as well as economic

terms, to turning round the economy. It had brought public borrowing under control, and had promoted an earlier fall in interest rates than would otherwise have been possible. Politically, although there had been a lot of opposition at the time, it had convinced the public of the Government's determination to stick to its strategy. Dr Feldstein expressed an interest in this. He thought it would be very useful to pass the message widely in the Administration, where similar tough decisions might have to be faced, and where the success of the British Government was much admired.

4. The Economic Secretary registered the Government's concern at the recent Supreme Court decision on unitary taxation.

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A P HUDSON
27 July 1983

CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR JACQUES DE LAROSIÈRE

Tuesday 26 July, at 11 am.

Present

Mr Jacques de Larosiere, Managing Director, IMF
Mr Bill Dale, Deputy Managing Director

Economic Secretary
Mr Wicks
Mr Alan Whittome, Counsellor, IMF
Mr Hudson

1. Mr de Larosière began by saying that he thought the continued fight against inflation was the most important policy for a healthier world economy. The recession had in fact helped the real underlying strength of the economy: the need now was to build on this strength, and not to refuel inflation. The Economic Secretary said there need be no doubt about the British Government's commitment to the elimination of inflation: the measures announced on 7 July demonstrated this.

2. Mr de Larosière saw two main threats to the improving world economy: the size of the US deficit, with its implications for interest rates; and the international debt problem.

The US position

3. Mr de Larosière was concerned that the size of the deficit would inhibit recovery, because the US Treasury and the private sector would be competing for finance. Although the actual deficit would come down from the \$200 billion projected for the current year, he saw no attack being made on the structural \$100 billion deficit which was at the core of this.

4. Mr Dale also did not think this structural problem would be tackled. The Economic Secretary said that, although tough decisions would be required, the British experience over 1981 had shown that these could be politically advantageous in demonstrating the Government's commitment to its strategy.

5. Mr de Larosière said that Secretary Regan, speaking at a meeting recently, had not denied the link between the deficit and interest rates. Mr Regan had acknowledged that the size of the deficit would have to be tackled, though this could not be done through increasing taxes, which would merely give Congress more money which it would turn into extra spending. Mr de Larosiere feared that this approach was tantamount to saying that nothing would be done. His own view was that the best prospect of reducing the deficit would be through a combination of indirect tax increases and cuts in non-defence spending. The UK experience in 1981 could be useful in demonstrating the viability of such a measure to the Administration. Action was needed soon: measures for the 1984 Budget could be very helpful as a signal to the markets of the Administration's resolve.

The International Debt Problem

6. Mr de Larosière said that steady progress was being made in tackling the problem and monitoring the position of countries in trouble. Some people had suggested radical approaches, such as "internationalising" all the large sovereign debt. He was sure that such approaches would not be viable, because there would be a lack of political support in eg the United States, nor desirable, because it was vital to maintain the direct link between countries and their creditors.

7. Of the major programmes, that for Mexico was on track, as was that for Argentina, apart from a problem on wage levels and the UK's particular problem (paragraph 8 below). The position on Brazil was more worrying: it was critical to successful recovery that the 1984 Budget should build on recent moves in the right direction. The

letter of intent which the Fund had recently been given did not promise this - it merely covered the most immediate problems of 1983 - so his staff would be seeking a more satisfactory programme.

8. Mr de Larosière had made it clear to the Argentines that the Fund management would not support continued eligibility to draw if the discriminatory restrictions against UK banks and companies were not lifted. The Argentines said that they could not make such a move for political reasons. This meant there was a risk of the IMF programme, and with it the commercial bank programme, being stopped, and Argentina going into practical default.

9. The Economic Secretary stressed how critical an issue this was for the UK Government in political terms. Much of the difficulty in getting the International Monetary Arrangements Bill through Parliament had resulted from the objections of MP's to loans to Argentina, and the military uses to which they could be put. The Government had supported the IMF programmes as the best route for the debtor countries back to normal economic and political relations; and the decision to take the IMA Bill early, when it would have been easier to delay, was a part of this. He said that the Government was very grateful for the Managing Director's help to date in standing firm on the non-discrimination conditions attached to the IMF programme for Argentina.

10. Mr de Larosière said that the Fund would be absolutely firm. He thought some gesture from the UK on the exclusion zone would help the Argentines. The Argentines might try to play on the general fear of a country defaulting, but he thought it would be against their interests to do so.

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A P HUDSON
27 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR C FRED BERGSTEN

Tuesday 26 July, at 12.15 pm.

Present

Mr C Fred Bergsten, Director, Institute for International Economics

Economic Secretary
Mr Walsh
Mr Hudson

1. The Economic Secretary raised with Mr Bergsten two subjects of concern to the UK in the international field, unitary taxation, and the extraterritoriality of some US legislation. He stressed the strength of feeling on both issues.

2. On unitary taxation, Mr Bergsten agreed that the effects would be damaging to the US. He thought that a constitutional problem would emerge, with states trespassing on the remit of the Federal government. He thought that the sense of repugnance generated by extraterritoriality would only be realised by American opinion if another country retaliated.

3. Mr Bergsten asked about the economic effects flowing from the high pound between 1979 and 1981. The Institute for International Economics were studying methods of exchange rate management, and would be publishing something in the autumn. The Economic Secretary explained the basis of the UK stance. Mr Bergsten said that the US Administration had not become more pragmatic on the value of intervention in the exchange markets, in contrast to its positions on other subjects.

APH

A P HUDSON

27 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF LUNCH AT IMF

Tuesday 26 July, at 1.00 pm

Present

[See attached list]

1. Much of the lunch was taken up, rather surprisingly, with explanations of the methods by which the UK Treasury monitors and controls public expenditure. The lead-in to this came from the Economic Secretary stressing the importance the UK Government attach to public expenditure control. He and Mr Wicks explained the cash limit system, and its importance as a discipline on Departments planning future spending.

2. Otherwise, discussion covered the overall economic picture. Dr Penner made the point that the US deficit problem was more serious than the UK had faced not only because the deficit was higher as a proportion of GNP but also because this was true although the scope of US Federal Government activity was narrower than in the UK.

APH

A P HUDSON
27 July 1983

Lunch given by Mr Nigel Wicks at the IMF on Tuesday, 26 July, at 1.00 p.m. in Dining Room No. 1

'To meet Mr John Moore, MP, Economic Secretary to the Treasury.'

Guest List

Host

| | |
|---|---|
| Mr John Moore, MP | Economic Secretary to the Treasury |
| Mr Andrew Hudson | Private Secretary to Mr Moore |
| Mr Edwin M (Ted) Truman | Director, Division of International Finance, Federal Reserve |
| Mr Raymond Seitz | Executive Assistant to Secretary Shultz, Department of State |
| Mr Bruce Bartlett | Executive Director Joint Economic Committee |
| Mr William Cline | Institute for International Economics |
| Mr Shahid Husain | Vice President, Operations Policy World Bank |
| Dr Rudolph Penner | American Enterprise Institute |
| Mr Derek Smith | UK Alternate World Bank |

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH SENATOR JAKE GARN

Tuesday 26 July, at 3.00 pm.

Present

Senator Jake Garn, Chairman, Senate Banking Committee
2 staff members

Economic Secretary
Mr Walsh
Mr Hudson

1. There was some discussion of the IMF Bill, which Senator Garn had steered through the Senate. He was not optimistic about the Bill's getting a speedy passage through the House. Even if it did, it would emerge so heavily amended that the conference between the 2 chambers to sort out the differences would be very difficult.

2. The Economic Secretary referred to the UK Government's concern at both unitary taxation and the extraterratoriality in some legislation. On the latter, Senator Garn said that it resulted from very strong feelings in Congress and the Administration about aspects of the involvement of American or their subsidiaries with the Eastern bloc. The Economic Secretary saw this point of view, and undertook to pass it on to the Secretary of State for Trade and Industry, but he stressed the repugnance felt in the UK for extraterritoriality.

3. Senator Garn blamed the problem of the high Budget deficit solely on Congress. If the President's proposals had been passed in every detail, without amendment, there would be no problem. But Congress did not show the courage needed to implement spending cuts.

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A P HUDSON
27 July 1983

RESTRICTED

NOTE OF MEETING WITH DR BERYL SPRINKEL

Tuesday 26 July, at 3.45 pm

Present

Dr Beryl Sprinkel, Under Secretary for Monetary Affairs, US Treasury

Economic Secretary
Mr Wicks
Mr Hudson

1. The Economic Secretary began by explaining the purpose of his visit, and his interest in the prospects for the US economy over the next year, against the background of the high budget deficit, and fears of an increase in interest rates.

2. Dr Sprinkel said that he thought there was a shortage of evidence of a link between budget deficits and interest rates. His own view was that there was such a link.

3. However, he thought that monetary policy was also very important. The Administration had been urging the Fed for the past six months to cut the rate of growth of the money supply, but to do so without putting a brake on the recovery. They would continue to press this approach on the Fed.

4. The Economic Secretary explained the purpose, and successful outcome, of the measures introduced by the UK Government in the spring 1981 Budget. Dr Sprinkel said that if these measures were tried in the US, the deficit would not fall - Congress would merely spend more. The Treasury had calculated that of $100 extra tax revenue, 60-70 went in extra spending, and only 30-40 in reducing the deficit.

5. If the recovery was maintained, prospects were good for a fall in the deficit, because growth prospects were good. The President would contribute to the fall by vetoing spending increases. If monetary growth could be contained, there would be scope for interest rates to fall. But this did depend on a number of variables all working out well. At the moment, the markets did not believe inflation would stay as low as it was at present, and Dr Sprinkel tended to agree.

[6. The Economic Secretary's judgement on Dr Sprinkel's - relative - optimism is that it is in large measure the product of his views not having been heeded, and his having lost his former control and influence. What he is now doing is seeking an intellectual defence for the President's inability to act to restrain spending, and unwillingness to hold back on tax cuts.]

7. Dr Sprinkel was very interested in the Government's privatisation programme.

8. The Economic Secretary registered with him the concern felt in the UK about unitary taxation.

9. At the time of the meeting, Dr Sprinkel was heavily involved in lobbying Congressmen on the IMF Bill. He was confident that it would pass in more or less its existing form.

APH

A P HUDSON
28 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR ROBERT DEDERICK

Tuesday 26 July, at 5.00 pm

Present

Mr Robert G Dederick, Under Secretary for Economic Affairs, Commerce Department

Economic Secretary
Mr Walsh
Mr Hudson

1. Mr Dederick's responsibilities were in the Commerce Department, but his views were of considerable interest on general economic questions. The Economic Secretary began by asking how Mr Dederick saw the general economic outlook.

2. Mr Dederick said that the crucial question for him was why short-term rates had not fallen further at a time of recession. His own explanation was that the Fed had not reduced the rates further because it feared this would fuel inflation.

3. He did not see long-term interest rates as particularly high. He noted that the difference between this and previous large deficits was that these had always come about at times when private sector credit demand was weak.

4. The large deficits resulted from having indexation of personal tax reliefs, while not removing indexation of spending programmes.

5. Nothing was likely to be done about this in 1983 or 1984; there might be changes before the end of 1985. In the longer run, he thought there would be some form of consumption tax in the USA.

6. He saw dangers to inflation and eventually to interest rates in an over rapid recovery. There was no chance of fiscal action to put downward pressure on rates. Some move now to increase the rates slightly would increase the chance of the recovery not being too rapid. Such a move would be politically more feasible now than in 1984.

7. The Economic Secretary registered the concern in the UK at unitary taxation. He pointed out the danger to the USA, above all other countries, if other countries, particularly l.d.c.s introduced unitary taxation. Mr Dederick said that he had not previously thought very hard about unitary tax, because of his commitment to States' rights. He recognised now that he would have to think seriously about this difficult problem.

8. On the international trade picture, Mr Dederick thought it was now impossible for the USA to be an island of growth, because of its dependence on other markets and its relationship to the l.d.c.s and OPEC. The Economic Secretary stressed the UK's concern at trends towards isolationism and protectionism. He did not think was in the US's best long-term interets. Protectionism for steel was of particular concern. Mr Dederick mentioned agriculture as an area of concern to him: the US needed to export its surplus production, but faced subsidies, especially in the EC.

9. Mr Dederick acknowledged that if the $ fell to a more reasonable level, a lot of the pressures on US firms would disappear. Some major firms were in trouble.

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A P HUDSON
28 July 1983

NOTE OF MEETING WITH SENATOR JAMES McCLURE

Wednesday 27 July, at 9.30 am

1. During his visit to Washington, the Economic Secretary had a private meeting with Senator McClure, the Chairman of the Senate Committee on Energy and Natural Resources.

2. Senator McClure thought there was no possibility of action being taken on taxes or spending to reduce the high budget deficit before January 1985.

3. He thought that there would be another fast-breeder package later this year.

4. He added an interesting insight to the question of unitary taxation, by saying it was partly a debate between "producer" states and "consumer" states. Producer states were in favour of it, as a way of increasing their revenue-raising capacity; consumer states were very antagonistic, because it would make it much harder for them to attract industries.

APH

A P HUDSON

28 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR RAY SEITZ

Wednesday 27 July, at 10.30 am

1. During his visit to Washington, the Economic Secretary had a private meeting with Mr Ray Seitz, Executive Assistant to Secretary of State Schulz, whom he knew very well from the time when Mr Seitz was a First Secretary in London.

2. The <u>Economic Secretary</u> put Mr Seitz fully in the picture on the UK position on the question of further IMF help to Argentina while discriminatory restrictions against UK banks and companies were still in place. He stressed that this was an issue of the highest political sensitivity in London. <u>Mr Seitz</u> said he would pass this on to Secretary of State Schulz. He thought there need be no worry that the USA would wobble in its support for the UK's and the Fund's position. He had not been aware previously that the existence of discriminatory restrictions was not generally known in Parliament.

3. In conjunction with this, the Economic Secretary explained to Mr Seitz that the Government had decided to take the International Monetary Arrangements Bill through Parliament earlier than was necessary - and at the cost of using up considerable political credit - in order to demonstrate its commitment to the IMF as the route back to normalcy for debtor countries.

4. <u>Mr Seitz</u> raised the subject of Lebanon, which he said was not taking up 50% of the Secretary of State's time. He said that the presence of the British troops in the Lebanon peace-keeping force was critical.

A P HUDSON
28 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR STEPHEN BOSWORTH

Wednesday 27 July, at 11.00 am

<u>Present</u>

Mr Stephen Bosworth, Director, Policy Planning Staff, State Department

Mr Paul H Boeker

Economic Secretary

Mr Walsh

Mr Hudson

1. The <u>Economic Secretary</u> began by raising the issue of unitary taxation. He said it puzzled MPs and others in the UK, who did not think the Administration was putting sufficient effort into getting rid of it. He pointed out the dangers for the USA if l.d.c.s adopted this method of taxation. <u>Mr Bosworth</u> said this was an issue he had not gone into very deeply. Mr Boeker pointed out that national legislation would be needed to eliminate unitary tax, and this could take two years. The Economic Secretary was concerned at this: he said unitary taxation was the most serious single issue between the two countries; if resolving it took two years, there would be severe pressure for retailiation of some sort. Mr Walsh point out that in that time, more states might adopt unitary taxation: this was not a problem which would lessen or disappear if nothing were done.

2. <u>Mr Bosworth</u> explained that in his role as Director of the Policy Planning Staff at the State Department, his task was to challenge some of the conventional wisdoms there. There was a difference of view in the US Government as to whether high budget deficits mattered. Some thought that the capital markets were not

suffering, and that high interest rates were caused not by the high deficit but by expectations about inflation. His own view was that the high deficit did matter, leading to high interest rates, which had an adverse effect on the whole economy. He saw a link with the high dollar, and was concerned at the impact of this on the trade position.

3. Mr Bosworth thought there would be no action on the deficit until 1985. The scope for cutting spending had reached its limit in political terms. There would therefore be no spending cuts to reduce the structural deficit, so any changes would have to be on the revenue side, and he did not see the President changing his position. After 1985, something would have to be done to restore the revenue base. He thought the structural deficit was moving towards $130 billion. The Economic Secretary asked whether the high deficit would affect the quality and durability of the recession before then. Mr Bosworth thought there was a chance that favourable external factors, such as a fall in energy prices, might mean the recovery remained bouyant until 1985. A key point on oil prices was how far Saudi Arabia would accept the erosion of her market share over some years. Cuts in government spending would be resisted there as elsewhere.

4. Mr Boeker pointed to some of the other variables. The expectation that the value of the dollar would be sustained had led to investment in the USA. A change in, for example, the expectations for inflation could have a significant effect on this, and if the dollar began to fall it might fall fast. Certain commodity prices might rise: he noted that the US faced the possibility of a very bad feed grain harvest. There were a lot of variables, and if none went badly awry, action on the deficit early in 1985 might be soon enough.

5. Mr Bosworth asked about the position of the British economy. The Economic Secretary explained that the deficit and inflation were under control, the Medium Term Financial Strategy had been

reaffirmed, and that the recovery was a little way ahead of most of Western Europe. Major policy objectives for the next five years included reducing the burden of taxation and switching it further from direct to indirect taxes, and making progress on privatisation.

6. Mr Bosworth asked about the prospects for the EEC countries. The Economic Secretary was not optimistic in some cases. He noted that the pound had gone up quite markedly against some of the softer European currencies. Mr Bosworth thought there was a growing perception in Germany of a shift in relative prosperity against the Germans and in favour of the British. He thought German self-confidence was falling. The Economic Secretary agreed, and thought that the UK was benefitting from having taken tough decisions which had not yet been addressed elsewhere.

APH

A P HUDSON
29 July 1983

NOTE OF MEETING WITH MR RICHARD McCORMACK

Wednesday 27 July at 11.45 am

Present

Mr Richard McCormack, Assistant Secretary for Economic and Business Affairs, State Department

Economic Secretary
Mr Walsh
Mr Hudson

1. The Economic Secretary began by explaining the UK's concern about unitary taxation. Mr McCormack was very position in response. He said that the Administration was well aware of all the arguments against unitary tax, including the danger to the USA of l.d.c.s adopting the method. He realised that other States were likely to follow the 13 who used it at the moment. The subject had been discussed at a recent Cabinet Council of Economic Affairs, and no member had had anything to say in favour of the method. A working group had been set up to look into the problem urgently.

2. Mr McCormack thought the question of the deficit was absolutely essential to the prosperity of the USA. He thought there was no chance of action on it before the election, unless something tangible came up which threatened to abort the recovery, and could convince the Administration as a whole, and Congress, of the urgency of the problem. Public debate was not yet sufficiently compelling. But he thought the problem would be tackled early in January 1985 at the latest.

3. Mr McCormack said that he and most of his colleagues expected some downward pressure on oil prices next spring, for perhaps a $2 fall, unless there was a hard winter. This might come from a desire on the part of the Saudis to sell more oil. Otherwise, the Americans expected prices to be relatively stable over the next 5-10 years. The Economic Secretary said he would be interested in future indications of US views on this subject, particularly on the timing of changes.

4. The Economic Secretary explained the UK's position on exterritoriality. He did not think that otherwise well informed and influential American opinion appreciated fully the repugnance felt in the UK over this. Mr McCormack said he realised certain US actions had touched a sensitive nerve. But the UK had done similar things occasionally. The aim should be to remove the real irritants to good relations. The Economic Secretary said he understood this, but stressed that the American extention of control over overseas subsidiaries was a very sore point.

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A P HUDSON
29 July 1983

ECONOMIC SECRETARY TO THE TREASURY

LUNCH AT WORLD BANK

Wednesday 27 July, at 1.00 pm

Present

(see list attached)

US Economy

1. Mr Wicks began by asking Mr van Doorn Ooms for his view on the familiar question of the US deficit.

2. Mr van Doorn Ooms said that he saw very little chance of any action to reduce spending. There was also a lack of enthusiasm in the Administration for any move forward on a revenue Bill. This meant that the deficit was likely to remain roughly its present level at least until the election.

3. Governor Wallich admitted to being perplexed at the behaviour of the monetary aggregates. His view of the fiscal outlook was the same as that of Mr van Doorn Ooms. His own view was that it might be possible to achieve tighter monetary targets if there were a smaller budget deficit. But he did not think Congress would share this view: they would expect some relaxation of monetary discipline as a quid pro quo for a tigher fiscal stance. Given present circumstances, the view of the monetarists was that when interest rates fell, they would fall only slowly.

4. Governor Wallich said that he thought the large trade deficit might not have its expected effect of downward pressure on the dollar. In any case, the strong dollar was not necessarily a bad thing for the rest of the world. Commodity prices were measured in dollars, so a strong dollar had some advantages for l.d.c.s.

Other countries could decouple from the dollar, allowing their currency to fall against the dollar, and becoming able to reduce their interest rates. The USA stood to suffer, as it was already suffering, in its trading position. Mr Wicks thought that the most important and inescapable thing for the debtor countries was that their debt was denominated in dollars, and they suffered from the high (dollar) interest rates which they had to pay on the debt.

World Economy

5. Mr Habermeier wondered whether some of the current international economic problems could be eased by an expansion of the international money supply. The Economic Secretary said that this was not an approach which appealed to the UK Government; Mr Wicks put the argument that it would merely fuel inflation. Mr Habermeier did not think this was necessarily the case, but his view had little support in discretion.

6. There was some discussion of the pros and cons of the proposition that the IMF should borrow more from commercial banks, and particularly of whether this would lead to more or less lending direct from banks to individual countries. There was no great enthusiasm for more IMF borrowing, though nobody sought to suggest it would be wrong under all circumstances. Mr Qureshi made the point that the IMF would not want to duplicate the role of the World Bank in the financing of longer-term programmes, and all agreed with this. Mr Habermeier confirmed that any borrowing would be short-term.

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A P HUDSON
2 August 1983

Lunch given by Mr Nigel Wicks at the World Bank on Wednesday, 27 July, at 1.00 p.m. in Dining Room No. 3

'To meet Mr John Moore, MP, Economic Secretary to the Treasury

Guest List

Host

| | |
|---|---|
| Mr John Moore, MP | Economic Secretary to the Treasury |
| Mr Andrew Hudson | Private Secretary to Mr Moore |
| Mr Alan Granwell | International Tax Counsel<br>US Treasury |
| Mr Van Doorn Ooms | Chief Economist, Economic Analysis<br>House Budget Committee |
| Mr Richard McCormack | Assistant Secretary<br>Economic and Business Affairs<br>Department of State |
| Mr Moeen Qureshi | Senior Vice President, Finance<br>World Bank |
| Mr Walter Habermeier | Treasurer, IMF |
| Mr Alan Whittome | Counsellor, IMF |
| ~~Mr Marc Leland~~ | ~~Assistant Secretary for International Affairs, US Treasury~~ |
| Mr Harry Walsh | Counsellor (Economic), British Embassy |
| Governor Henry C Wallich. | Federal Reserve Board |

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH REPRESENTATIVE STEPHEN NEAL

Wednesday 27 July, at 3.00 pm

Present

Representative Stephen Neal, Chairman, Sub-Committee on International Trade, Investment and Monetary Policy

Economic Secretary
Mr Walsh
Mr Hudson

1. The main topic of discussion at this meeting was the IMF Bill, which was being debated in the House that week. Mr Neal was responsible for the Bill, as Chairman of the relevant sub-committee of the House Banking Committee.

2. Mr Neal did not think that the Bill could be passed that week - there were simply not enough votes behind it. He was confident that a version of the Bill would pass eventually - the measure at the heart of it was simply too important not to prevail. However, perception of that was not sufficiently wide-spread at the moment.

3. The Administration was fairly confident that the Bill would pass in the current week, as the Economic Secretary had gathered from earlier meetings. But they had not "counted noses". They underestimated the depth and breadth of feeling against the Bill, and hence the amount of lobbying that would be required, particularly of the Administration's own natural supporters, for the measure to command a majority. Such lobbying as had taken place had been too little and, for a vote in the current week, too late. Opposition was coming from a number of angles: from those who thought it was merely a measure to bail out the banks; from those who thought

money would be better spent on social programmes at home; from those who thought extra facilities for the IMF were simply wasted; and from some Democrats who were disinclined to vote for an Administration measure when the Administration had not mustered its own forces in support.

4. The <u>Economic Secretary</u> explained that, under a very different Parliamentary system, it had been difficult to steer the comparable Bill through the House of Commons. Opposition had come similarly from all sides, with the added particular complication of loans to Argentina. Nonetheless, the Government had felt it important to take the Bill early, although this was not politically the best time, because an early passage would demonstrate commitment to the IMF as the best route for debtor countries back to normalcy, and would, it was hoped, help other countries to secure early passage of their Bills. The Chancellor had written to Treasury Secretary Regan with this in mind. The Economic Secretary mentioned to Mr Neal two of the main arguments he had used in getting the Bill through: that the IMF was the best route back to normalcy; and that a default would have very serious consequences for banks in the USA or the UK with, for example, a threat to the jobs of employees in the banking sectors.

> [5. The Economic Secretary judged Representative Neal to be a thoroughly competent and able man. He thought Neal's explanation of the reasons why the Bill was running into trouble were right. Neal himself had done all could.]

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A P HUDSON

2 August 1983

CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH CHAIRMAN VOLCKER

Wednesday 27 July, at 4.00 pm

Present

Mr Paul Volcker, Chairman, Federal Reserve Board

Economic Secretary
Mr Walsh
Mr Hudson

US Economy

1. Chairman Volcker did not depart from the broad consensus that no action would be taken to reduce the US structural deficit before 1985. Indeed, he feared that once the Budget for FY 1984 had been considered in Congress and in the Administration, and in negotiations between the two, it was unlikely that the figure for the deficit envisaged in the Conference Resolution of Congress ($179.3 billion) could be achieved.

2. This would make it very difficult for interest rates to come down. The current slight shading upwards might prevent a larger rise later. But Congress would only act on the deficit if there were a sharp increase which they saw as stemming from the budget deficit and threatening the recovery.

International Issues

3. There was not very much discussion of the international trade picture. But Chairman Volcker accepted that the dollar was currently at a very high level, and was aware of the fears that if it began to fall it might fall rapidly and sharply.

4. On the Brazilian situation, Chairman Volcker said that the Government's decision to begin to take the necessary tough measures on the economy (beginning the de-indexation of wages) had come as a considerable relief. The situation would, of course, have to be monitored with care , and it was particularly important to ensure that the recent progress was build upon in 1984. For the present, financial assistance should be maintained and if IMF assistance were delayed the necessary bridging operation should take place. He hoped that the UK would agree.

5. On the IMF Bill, Chairman Volcker confirmed that the President had become involved in the process of securing support for the Bill. The Economic Secretary explained that the pattern of opposition in the UK Parliament had been fairly similar to that in Congress. The Government had decided to take the Bill early to show its support for the IMF as the route back to normalcy for the debtor countries. Chairman Volcker was sure that this would be a useful point for the Administration to pray in aid in rallying support.

APH

A P HUDSON

3 August 1983

CONFIDENTIAL

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH CHAIRMAN VOLCKER

Wednesday 27 July, at 4.00 pm

Present

Mr Paul Volcker, Chairman, Federal Reserve Board

Economic Secretary
Mr Walsh
Mr Hudson

US Economy

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2. This would make it very difficult for interest rates to come down. The current slight shading upwards might prevent a larger rise later. But Congress would only act on the deficit if there were a sharp increase which they saw as stemming from the budget deficit and threatening the recovery.

International Issues

3. There was not very much discussion of the international trade picture. But Chairman Volcker accepted that the dollar was currently at a very high level, and was aware of the fears that if it began to fall it might fall rapidly and sharply.

4. On the Brazilian situation, Chairman Volcker said that the Government's decision to begin to take the necessary tough measures on the economy (beginning the de-indexation of wages) had come as a considerable relief. The situation would, of course, have to be monitored with care , and it was particularly important to ensure that the recent progress was build upon in 1984. For the present, financial assistance should be maintained and if IMF assistance were delayed the necessary bridging operation should take place. He hoped that the UK would agree.

5. On the IMF Bill, Chairman Volcker confirmed that the President had become involved in the process of securing support for the Bill. The Economic Secretary explained that the pattern of opposition in the UK Parliament had been fairly similar to that in Congress. The Government had decided to take the Bill early to show its support for the IMF as the route back to normalcy for the debtor countries. Chairman Volcker was sure that this would be a useful point for the Administration to pray in aid in rallying support.

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A P HUDSON

3 August 1983

NOTE OF ECONOMIC SECRETARY'S VISIT TO NEW YORK,

28-29 JULY 1983

1. This note records the main points emerging from the Economic Secretary's visit to New York, which followed straight after the visit to Washington (recorded in a series of separate notes).

2. The Economic Secretary had meetings with the following:

(a) Mr Henry Fowler, Chairman, Goldman Sachs and Co, and former Secretary to the US Treasury;

(b) Mr Lewis Preston, Chairman, and Mr Rimmer de Vries, Morgan Guaranty Trust;

(c) (Lunch) Mr Ralph Peters, Chairman, Discount Corporation, and colleagues;

(d) Mr Sam Cross, Executive Vice-President, Federal Reserve Bank of New York;

(e) Mr Gary Wenglowski, Chief Economist, Goldman Sachs and Co;

(f) Mr Thomas Theobald, Vice Chairman, Citicorp;

(g) Mr P P Kuczynski, President, First Boston International.

3. The Economic Secretary also had private meetings with Board Members from Dean Witter Reynolds Inc, and with Mr Henry Kaufman of Salomon Brothers.

4. The purpose of the visit was, in short, to test out the conclusions drawn from the Washington meetings on people working in the financial markets.

5. The core of all the meetings was therefore discussion of the general outlook for the US economy. The Economic Secretary began by explaining the structure of the new Treasury team, and the purpose of his visit. He was interested in the US economy because of its significance for the decisions which would have to be taken in the UK over the coming months, and for the worldwide implications of movements in American interest rates and the dollar. His overwhelming impression from his meetings with members of the Administration, in Congress, and with Chairman Volcker, was that it was most unlikely that any action would be taken to reduce the high structural deficit before the Presidential election at the end of 1984. Congress would not agree to any spending cuts; and the President would brook no tax increases. The deficit would therefore continue at a very high level, and most people thought this would put upward pressure on interest rates, although this was not a unanimous conclusion. The outlook for the economy was thus not very auspicious: the high deficit might put a brake on recovery if it led to higher interest rates, and might also lead to inflation.

6. None of the people we met in New York disagreed with these conclusions. There was no suggestion that the deficit problem would be addressed, unless a particular event - the obvious possibility being a sharp rise in interest rates - forced Congress and the Administration to address it. And there was a general expectation that interest rates would go up rather than down, though nobody forecast a rapid increase. There was some concern at how long the dollar could be sustained at its present level, given the large trade deficit; and the fears outside the USA that this would lead to more protectionism were acknowledged.

7. The person who came nearest to departing from this consensus was Mr Theobald (of Citicorp). His immediate response to the Economic Secretary's summary of the position was to say that interest rates were not necessarily high, in historical terms, or measured against the market's expectations of future inflation. He also questioned whether the level of interest rates was inhibiting business behaviour in any way. There was certainly no shortage of venture capital in the USA - he quoted some madcap schemes which had found substantial financial backing and then, predictably, failed. Indeed, Citicorp had decided recently to expand their venture capital activities in the UK, where there was unfulfilled demand.

8. Mr Fowler though that the deficit could not be tackled without tackling two elements in it: firstly, the revenue side as a whole; and secondly, the indexed flat-rate entitlements (benefits), where demographic changes were increasing the costs, and where he thought the case for some form of means-testing was overwhelming. He did not think the political will existed to tackle these problems now. But it was not impossible; as Treasury Secretary, he had presided over the last US budget surplus (in 1968), and he had achieved this by pushing through some unpopular tax increases. He was thus interested in the Economic Secretary's explanation of the purpose and consequences of the spring 1981 Budget, when indirect taxes had been increased and certain benefits de-indexed against strong opposition at the time, but with the result of demonstrating to the public the Government's resolute determination to keep the deficit down and get rid of inflation, and hence some gain in political terms. Mr Fowler hoped the message had been heard in Washington.

9. Mr Fowler thought it was very important for international understanding that Ministers, and particularly heads of Government, should meet regularly. He believed this was the only real way better international cooperation could be achieved.

10. Mr Wenglowski (of Goldman Sachs) was concerned about the "crowding out" resulting from the high deficit. The very substantial Government borrowing was making funds harder to come by for other potential borrowers: the l.d.c.s and the private sector. He thought, however, that the Fed was likely to be forced to temporise and to delay rises in interest rates because of the political pressure the "crowded out" could apply.

11. Mr Wenglowski said he thought the high deficit would lead to inflationary pressures. But it was the interaction of the high deficit with the desire for a tight monetary policy which caused the problem of heavily indebted l.d.c.s.

12. Mr Eddie Hanlon, of the Discount Corporation, shared the general expectation that interest rates would go up. But he could not see any point in the Fed's present policy of "gradualism" - allowing rates to shade up gradually, in the hope of avoiding a major increase later. This had been tried before, and had never worked.

13. Discussion with Mr Preston and Mr de Vries at Morgan Guaranty concentrated on international economic issues. They were interested in the UK's policy on intervention and the exchange rate: Mr de Vries had heard reports that the UK was now pursuing a policy of managing rates to keep them within specific target zones. The Economic Secretary said that there had been no change in policy. Clearly, the extent of intervention would fluctuate from time to time dependent on circumstances, but such fluctuations should not be misinterpreted as a change of policy. This reassured Mr de Vries, who had been surprised by the suggestion that the UK had target zones.

14. Both Mr Preston and Mr de Vries were very concerned about the problem of debtor countries. They thought that the present approach was right. Brazil was particularly worrying: it was vital here to link the 1983 and 1984 programmes to try to ensure progress was maintained.

15. They wondered what could be done about the valuation of the dollar against the yen. The Economic Secretary saw this as part of a wider question for the West of how to get on in economic terms with Japan.

16. They thought there would be some weakening of oil prices in the spring. Internal pressure would make Saudi Arabia, and possibly other OPEC countries, want to sell more oil.

17. On the privatisation programme, they were optimistic that a proportion of the shares in the various companies could be sold in the US markets.

18. Mr Kuczynski and his colleagues at First Boston (Mr Donnelly and Mr Batten) were similarly optimistic about the prospects for share sales.

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A P HUDSON

3 August 1983

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