Prime Minister.

PPS.
The Prime Minister may wish to be aware of this, before tomorrows economic meetings.
N.C.W.
20.2.

c. Mr. Butler
PS/HMA
Head of C

Mr. Wicks

1. I attach a note on Federal Reserve Chairman Volcker's statement to the Senate Banking Committee on monetary policy in 1985.

No need for PM to read.

2. You also asked whether Treasury Secretary Baker had referred to US policy on intervention in foreign exchange markets during recent testimonies before Congress. Baker testified both today and yesterday. His statement (same for both occasions) is attached and contains no reference to intervention. I understand from the US Treasury that in response to questions at today's hearing Baker would only say that some intervention had occurred, US policy was to intervene to calm disorderly markets, but there had been a slight softening of policy as revealed in the G5 Statement. He refused to give details on the amount of intervention, the factors which led to a decision to intervene and whether this recent move(s) had been co-ordinated with other G-5 countries.

3. I attach a copy of your telegram reporting Baker's comments over the weekend on this issue, as requested.

Julian Exeter

J. Exeter

20 February, 1985

US MONETARY POLICY

1. In a statement on monetary policy to the Senate Banking Committee, Federal Reserve Chairman Volcker announced small increases to the growth ranges for M2, M3 and the credit aggregate for 1985 compared to the ranges which had been provisionally set for 1985 last July, but added that they did not represent any change in policy intentions. The new ranges and performance in 1984 (from a fourth quarter base) are as follows:-

	Ranges for 1985	Ranges for 1984	Actual Growth in 1984
	(	Percent Growth	)
M1	4-7	4-8	5.2
M2	6-9	6-9	7.7
M3	6-9.5	6-9	10.5
Domestic Non-Financial Debt	9-12	8-11	13.4

2. Volcker stated that growth of money and credit of this order would support another year of satisfactory economic expansion without an acceleration of inflation. It was consistent with the Federal Open Market Committees (FOMC) forecast for 1985 of growth of nominal and real GNP growth centered around 7.5-8.0 percent and 3.5-4.0 percent respectively (fourth quarter on fourth quarter), inflation at 3.5-4.0 percent and unemployment falling to 6.75-8.0 per cent by the year end. This forecast is similar to that of both the Administration and the CBO.

3. With strong growth of the money supply at present, Volcker acknowledged that all the aggregates would start above the target ranges, but was confident that growth, especially for M1 and M2, would slow during the year consistent with the growth ranges. The upward revision of the broader aggregates appears to reflect a recognition that credit growth will continue to be strong in 1985, partly reflecting the size of the budget deficit.

4. On monetary policy Volcker said that the progressive easing of reserve conditions had come to an end and open market operations were being conducted more cautiously. Referring to the decisions to ease policy in late 1984 Volcker said that both the strength of the dollar and the success in lowering inflation were contributing factors.

5. During his statement Volcker stressed the link between trade and budget deficits, arguing that high deficits, rising imports and strong investment had been reconciled by a growing volume of net capital inflows, amounting to nearly $100 bn in 1984. Volcker stated that "the stability of our capital and money market is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets" and "we are in a real sense living on borrowed money and time." The resulting strength of the dollar had caused imbalances within the economy, especially among exporters and farmers. As on previous occasions, Volcker urged the Congress to lower the budget deficit. In response to a question Volcker repeated his view that the deficit for FY 86 should be cut by some $50 bn.

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6. During a discussion on the credit problems of farmers in the mid west, Volcker said he believed there would be heavy pressures on some banks, but he believed these could be contained without affecting the financial system.

7. Volcker welcomed the reduction in inflation and a probable decline in inflationary expectations. But he warned that some of those factors contributing to the decline in inflation might not be lasting. In addition Volcker stressed on several occasions his firm resolve not to succumb to any potential pressures to monetize the debt. In response to a question Volcker acknowledged they might arise if there were only modest cuts in the deficit. But an expansionary monetary policy under these conditions would lower growth and raise inflation.

8. In response to further questions Volcker said several factors were responsible for the strength of the dollar including US interest rates and favourable growth prospects. To date intervention in foreign exchange markets had been limited and was only undertaken when both the Treasury and the Federal Reserve agreed it would be desirable.