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NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND SECRETARY BAKER AT THE BRITISH EMBASSY, WASHINGTON ON THURSDAY 21 FEBRUARY 1985 AT 0930 HOURS

Present:

Prime Minister	Secretary Baker
Minister (Economic) HM Embassy	Under Secretary Sprinkel
Mr. F.E.R. Butler	Assistant Secretary Mutford
	Deputy Secretary Darman
	Deputy Assistant Secretary Dallara

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The Prime Minister suggested that the meeting might start by discussing the strength of the dollar which was rising further against the deutschmark that morning. She had no doubt that this was partly due to the political strength and stability of the United States. Unlike the European countries, there was no prospect of an extreme socialist government in the United States. But she was worried about the continued rise of the dollar because it did not appear to be based on a sustainable situation. On the other hand, the ability of governments to take effective action against the market in the short term appeared very limited.

Secretary Baker agreed with this view. The US Administration's experience of intervention showed that it had limited effectiveness. Other solutions, such as inflation or an import surcharge, were unattractive. The Prime Minister agreed with the latter view.

Mr. Sprinkel added that the US economy appeared much more flexible in the use of resources than European countries and more competitive in labour markets. The Prime Minister agreed. The US economy did not suffer so much union resistance to change

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and she referred to the chart prepared by Secretary Baker showing the greater degree of support for long term unemployment in Britain and France compared with the United States.

Secretary Baker referred to the President's youth opportunity minimum wage proposal. The Prime Minister said that the British Government were trying to remove obstacles to the provision of jobs for young people at an economic wage. The Wages Council system was an obstacle here, but there was strong labour resistance to the removal of that system.

Secretary Baker said that, although the rise in the dollar was not justified by the relative trade position, it could go on for some time. It did not appear to be based purely on speculation. Other factors such as the long-term prospects of the US economy and the range and flexibility of types of investment offered in the US market were a factor. In response to a question from the Prime Minister, Mr. Sprinkel confirmed that nevertheless a lot of the movement into the dollar was short-term money, and the Minister (Economic) confirmed that there were estimates that 10% of movements were trade related and 90% investment related.

Secretary Baker referred to the action which the United States Government had taken to improve the attractions of the yen as an outlet for investment. A three point programme had been negotiated between the US and Japan last year covering deregulation in Tokyo, freeing the market for the Euro-yen and removing obstacles to the establishment of financial institutions in Japan. There was an agreed programme of further steps to be taken in April and the market was itself inducing the Japanese to go further. The Prime Minister commented that there was a better prospect of liberalisation in Japan under Prime Minister Nakasone.

Summing up the discussion, the Prime Minister said that it was very trying for Britain, when the fundamental problems in the economy were being tackled and some success was being achieved, to see nevertheless the value of its currency at an all time low against the dollar. The only long-term solution

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appeared to be the reduction of the US deficit. One of the major problems for Western economy was the relentless pressure on the growth of public expenditure, particularly on social programmes. Following work done by OECD, she had tried to have a reference included to this problem in the final communique ofthe London Economic Summit, but other Heads of Government had been reluctant to agree. The Minister (Economic) added that the IMF were producing further material on this problem.

Secretary Baker said that there was general agreement in Washington on the need to reduce the deficit. The only difference was about the method. The President was determined not to increase taxes since this would increase the proportion of the national income taken by the State. The President was tackling the pressure for growth of social programmes. Defence, which had constituted 48% of Government spending under the Kennedy Administration, now only amounted to 29%.

FERB.

21 February 1985