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CONFIDENTIAL

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND THE CHAIRMAN OF THE FEDERAL RESERVE BOARD AT THE FEDERAL RESERVE BUILDING, WASHINGTON ON THURSDAY 21 FEBRUARY 1985 AT 1145 HOURS

Present:

Prime Minister	Mr. Paul Volcker
HM Ambassador	
Minister (Economic)	
Mr. F.E.R. Butler	

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International Exchange Markets

The Prime Minister began by referring to the strength of the dollar in the foreign exchange markets that morning. Mr. Volcker commented that the market had interpreted his remarks on the previous day about an end of the period of loosening on the monetary policy as an indication that it was to be tightened up.

The Prime Minister said that she felt uncomfortable about the present position because it was built on an unstable foundation. If there was a reversal in the rise of the dollar, the movement might be sharp. She had noted that members of the Administration had argued to her that morning that action to reduce the deficit might perversely strengthen the dollar further by showing that the one weakness in the Administration's policy was being corrected.

Mr. Volcker said that the latter was a currently fashionable view. But he agreed with the Prime Minister's analysis of the present position. He believed that effective action would not be taken about the deficit in current circumstances. If it were, he believed that it would check the rise in the dollar because market interest rates would come down. In current circumstances, however, he did not know whether he was worried most about the prospect of a further rise in the dollar or of a fall. Certainly,

/ if there was

if there was a fall and nothing had been done about the deficit, the pressures on the Administration to take action would be very strong. But it would be an uncomfortable situation in which to have to act.

The Prime Minister asked about the damage of the current level of the dollar to exports and agriculture. Mr. Volcker said that the effect on businesses was likely to occur through their investment plans. Although much of the talk was exaggerated, there was widespread pessimism among businessmen about further investment in the United States at current rates of the dollar. Of $20b expenditure on new plant and equipment in the previous year, $12b was represented by imports. In the event, market forces would reverse the rise in the dollar but, particularly if Congress resisted pressures for protection, there might be no reversal this year.

Mr. Volcker continued that, in the interests of not causing further appreciation of the dollar the Fed had been compromising on monetary control. Money supply on all measures had been going up fast. The Prime Minister said that the monetary policy had also been too lax in the United Kingdom, but action had now been taken to tighten it up. She thought that it would be necessary to keep United Kingdom interest rates above United States' rates for the foreseeable future. There was a bill mountain at present and this gave scope for "round tripping" by discounting bills and putting them on the money market.

Mr. Volcker said that the policy of co-ordinated intervention agreed at the January meeting of the Group Five had not worked Intervention had been in too small amounts to be effective. He acknowledged that intervention could have an effect if it was on a large enough scale and undertaken at the right psychological moment but that had not happened so far. He thought that there was scope for expansion in both Germany and Japan: both had surpluses on their current accounts and a good record on inflation, but in order to prevent a further depreciation in their currencies against the dollar they were keeping conditions tight and this was having an unnecessarily depressing effect on their economies. Conversely, if they were to let up a bit, the

/ resultant growth

resultant growth might well cause their currencies to appreciate. He did not believe that the same argument applied to the United Kingdom.

United States Banking

Mr. Volcker said that the weak condition of business, and particularly farming, would bring many collapses among small banks, particularly since many loans had been secured on land of which the price had now collapsed. There would also be problems for banks like Crocker. Most of the depositors in these banks would be protected by government insurance for depositors up to $100,000.

Mr. Volcker said that he was concerned about the increasing tendency of banks to take in short-term money, often overnight, against medium and long-term loans, in order to square their books. He had found it difficult to enforce more prudent arrangements in the United States because the banks pointed out that this prevented them from being competitive with banks in other countries which had looser arrangements. One of the problems was that memories of banking crashes were now so distant that nobody feared them anymore. He welcomed the work which the Bank of England were leading in Basle to introduce tighter regulations on a co-ordinated international basis.

Oil Prices

Mr. Volcker said that a reduction in the oil price to $25 would be unlikely to cause any great problems. Beyond that, there would be difficulties for a number of countries and for banks which had lent them money. But many people in the United States would nevertheless be glad to see the oil price drop to $20 or below because it would raise the rate of growth. He doubted whether the oil price would drop that far, since stocks were undoubtedly low and would have to be replaced in the next twelve months.

/ Debtor Countries

Debtor Countries

Mr. Volcker said that he was not optimistic about Nigeria. Brazil had loosened its policy after reaching agreement with the IMF and inflation was now running away. The Managing Director of the IMF had therefore declined to give his approval to a bank loan and it was hoped that the new government of Brazil would reach a new agreement on taking up office. Mexico was also having problems, partly because there was an internal struggle between those who were unwilling to accept changes in established methods of doing things and the rest. But it was likely that a new agreement could be negotiated. He was reasonably optimistic about Venezuela but not about Argentina where inflation was out of control and the Government was unwilling to take any action which would lower the rate of growth. Some progress had been made about the Philippines but the present regime was unlikely to last in tne long run. He acknowledged that things had not been going well for South Africa but this was not high on his order of concerns.

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21 February 1985