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Date: November 12, 1987

To: Mr. David Norgrove

From: Alan Walters

Fears of 1929-1933

The stock market crash has recalled cathartic comparisons with 1929. But the crash of 1929 did not cause the great depression of the 30s. That was due to the perverse government policies which were used to deal with the recession that followed the crash. In all countries these intially took the form of (a) contracting the money supply "to defend the exchange rate", (b) fiscal stringency, and (c) protection. Britain changed her policy with respect to (a) and (b) with dramatic results in 1931, but the United States continued its defence of the dollar until 1933/4 - and saw its money supply, price level, and real GNP collapse by one third.

(1) A recession or at least a substantial slowdown in growth is likely next year. The important job for governments is to avoid the errors made in the 1930s so that a modest recession does not become a disastrous depression. That is the short run task of governments. The long run task is to ensure that, in dealing with the short run, the goal of inflation-free growth is not (2) jeopardised.

A good start has been made. Monetary authorities have properly responded to a potential liquidity crisis by supplying cash and easing monetary policy. This, however, came into conflict with the Treasury Secretary's view that the United States, Germany, Japan and the U.K. should "defend" the dollar against further fall. A defence of the dollar was rationalised in terms of promoting confidence in international markets (just as in 1930) and has lead to various forms of international accords which would have immobilised monetary policy. Fortunately the Louvre accord and the attempt to use monetary policy to support the dollar have been, I hope, permanently shelved. (by holding money tight)

The loss of nominal wealth associated with October 19th is likely to slow household and business spending. We enter a recession. A decline of interest rates is a natural concomitant - and it would help sustain investment, lower the dollar, encourage exports and so promote recovery - with beneficial effects on the rest of the world. If a policy of pegging the dollar were pursued, the reduction in the current account deficit would be slowed down and interest rates would have to be high, perhaps

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much higher, to compensate for the expectation that, despite the government's temporary success in pegging the dollar, the value of the dollar must decline.

The dilemna is that there is an apparent contradiction between this short run monetary policy of transitory ease and the responsible long run policy of containing inflation. So often in the past, an expansion of the money supply and restrained interest rates, adopted for sensible liquidity reasons, have become politically too attractive to forgo. They have then fueled inflation, with all its corrosive effects and the final result "stagflation". The pervasive long run objective must be one of stable financial conditions consistent with non- or at least low- inflation. We must not allow policy to degenerate again to staggering from one financial crisis to another.

An even greater dilemna confronts the United States in fiscal policy. The federal deficit is has been and is far too high in these full employment years. In the long run the federal deficit must be reduced so that it is at least not unsustainable. With the onset of a recession, however, the deficit may well expand, in the short run, and, as "automatic stabilizers" offset some of the effects of the recession. In the long run we want the deficit down, in the short (recession) run we want it up. Unfortunately the United States has increased the deficit in past recessions, but failed to reduce it during the recovery. So it has burgeoned, and there is little room left for short run policy.

Again the issue is to fashion a credible policy of long term deficit reduction with a short term flexibility of response to varying economic activity, (like our MTFS). I do think that the reduction of the deficit by some $23 - 40 bn has become such an issue of confidence in government that it is desparately needed. But what is required for the long run is some institutional arrangement (such as a line item veto) for restraining congressional spending. There is a danger that in the United States we shall get the worst of both world.

With protectionism, fortunately, there is no such dilemna. Short and long run policies call for the same medicine - free trade. But political temptations are another matter. There is a real danger that we shall repeat the great error of the Smoot Hawley tariff of 1930 and the tide of world wide protection that accompanied it. It is remarkable that after five years of quite strong growth and full employment, the tide of (congressional) protectionism is waxing, not waning. It can only become a flood if even a mild recession occurs. The power of the president to veto such demands has been much reduced. For my part I doubt if we shall get anything so disastrous as a Smoot Hawley; but it will be serious.

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In short, the stock market collapse may be seen as a blessing if it forces the United States and the OECD countries to develop more responsible monetary, fiscal and exchange rate policies. With suitable and sensible government policies, any recession could be rendered mild and bearable. The wrong policies could bring an inflationary depression, both severe and intolerable.

Coordination

There is much to be said for "coordination" of governments if it takes the form of exchanging information and ideas. There are various forms of coordination that are inimical to good policies - an example is the much publicised Louvre agreement. In my view the bad-tempered publicised pressure that has been brought to bear on Germany and Japan is also counterproductive. The Germans and the Japanese want non-inflationary growth, and are themselves worried at building up such large dollar portfolios in conditions where the dollar can go only one way. Similarly we should acknowledge that the Germans probably know more about the behaviour and management of their economy than any outsiders. (For example it is said that the German economy can comforably absorb additional monetary expansion because the demand for money has increased, and there is a danger of a German deflation. I would urge that the Germans have very competent people examining these data and they have concluded that such is not the case. After all they have most to lose if they are wrong.)

If, however, one decides to give advice or indeed apply pressure on Germany or Japan, I suggest it is best done quietly and confidentially.

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FROM: ALAN A. WALTERS   Extension 33767 Dept/Div., No. 641/05

TO: COMPANY/ORGANIZATION: NO.10 DOWNING STREET (PRIME MINISTER'S RESIDENCE)
CITY AND COUNTRY: LONDON, ENGLAND
FOR ATTENTION OF: MR. DAVID NORGROVE - URGENT

FAX NUMBER/ MACHINE TYPE: (LONDON, ENGLAND 44-1) 222-8141 Extension 3188

SUBJECT: WORLD ECONOMY

Prime Minister
There is another paragraph on the end of this fax.
DRN
13/11.

PER OUR DISCUSSION, ATTACHED ARE MY THOUGHTS ON THE CURRENT SITUATION.

REGARDS,

[signature]

ALAN WALTERS

Attachment

cc:

Transmission Authorized by: Alan Walters, VPDEC [signature]

Original to be returned to: A. Walters   Room No.: S-9029

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