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Phelps - 15/6

INTERNATIONAL ECONOMIC SITUATION: US INTEREST RATE POLICIES

In his report to you of 12 June about the Vancouver meeting of personal representatives to prepare for the Ottawa Economic Summit, Sir Robert Armstrong has described the strong attack, led by the German representative, upon the United States Administration for the effects of the high level and volatility of their interest rates upon the economies and the exchange rates of their partner countries.

2. The atmosphere at the Finance Council in Luxembourg on 15 June - when we discussed the matter, formally and informally, at some length - was more restrained. We had the benefit of a full (oral) report from Gordon Richardson, as Chairman of the Committee of European Community Central Bank Governors: he had just come from their regular meeting in Basle. As recorded in Luxembourg telegram No.96 of 15 June, the Chairman, van der Stee, was able to record in his summing-up agreement that Finance Ministers should urge their Heads of State and Government to adopt a cautious approach on this subject at the Ottawa Summit. The Finance Council instructed the Monetary Committee to study the effect of interest rates on the economies of the Member States and to report in good time for a further discussion by the Finance Council at its next meeting on 6 July.

3. Other developments may alter the perspective before 19 July. But we cannot be sure what line Schmidt and Mitterrand will take

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on this issue at the European Council later this month and at the Ottawa Summit. They may decide, despite the moderate tone of Monday's Council, to criticise the United States sharply. We need therefore to think carefully about the line that the United Kingdom should adopt.

4. On the substance, our position appears to allow us to adopt a line intermediate between Europe and America. This may offer a chance of averting anything like a publicised quarrel between the two sides of Ottawa. A summit ending in tension and dispute on this issue could only be unhelpful to the financial and foreign exchange markets, and thus to everyone's efforts to bring better balance to their economies.

5. You have made it clear that we support all the main lines of United States policy. They are closely parallel to our own. Moreover, there are ambiguities about the European position. They claim to support the priority given to countering inflation. They have to acknowledge that a weak dollar has in the past brought severe disadvantages. They are not at all specific about what the United States should do to get lower interest rates while adhering to the basic policy and the anti-inflationary campaign. Neither France nor Italy, nor perhaps even Germany, can at present claim that they are entitled to criticise President Reagan's efforts. And the size of the German current account deficit is one reason why they - unlike the Japanese, whose current account is strong - have had to endure high interest rates in the wake of American conditions: it is not all the Americans' fault.

6. But we too are suffering in some degree from the behaviour of US interest rates. They have played a part in the recent fall in sterling, and have worsened our inflationary prospect. If, as we must expect, our current account weakens from the extreme strength of the end of 1980, we shall be more exposed to US

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interest rates. It would be very hard if the effort made and embodied in this year's Budget, so as to get our interest rates down, was nullified because the US was trying to reach its monetary targets too much through interest rates and not enough through expenditure cuts or tax measures. And we cannot deny that the seemingly endless switchback movement of US interest rates is destabilising and damaging.

7. So there is good reason why we should not distance ourselves from Europe by siding wholly with the Americans, however firm our support for the thrust of President Reagan's policies.

8. Can we help to find a practical outcome to the dispute? I think we might. For one thing I am told that the American Treasury Under Secretaries with whom the issues have been discussed in several fora over recent weeks may now begin to understand more clearly that they should not expect simply to set in place policies in the United States which affect others closely, and receive uncomplaining acquiescence. At the very least there should be greater willingness to explain and discuss, and an awareness of others' problems. The Europeans for their part cannot possibly expect, and indeed would not really want, any radical departure from the American anti-inflationary policy.

9. So the line might be that we all fully support the American determination to reduce inflation and to control monetary growth. But if too much weight has to be put on high interest rates in pursuit of these objectives, harmful burdens are thrust on to the other industrialised countries, who already face their own manifold difficulties in getting their economies on to a better basis. So it is fair to ask that enough of the burden should be carried by fiscal policy. And it would be helpful if the Americans could do more to make it plain that they are not relying solely on high interest rates, that their fiscal policy

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is designed to buttress their monetary policy, and that it will continue to do so not only this year but as the subsequent years of the President's programmes evolve. In addition we invite the Americans to consider again very earnestly whether they cannot reduce the volatility of their interest rates. This might involve looking at major changes in methods: but one thing which might be avoided somehow is the apparently excessive attention paid to the published weekly figures - in the UK we try to avoid too much emphasis being given even to monthly figures. Finally, we ask the Americans to bear in mind more generally that the fact that the dollar is the main world reserve currency does impose responsibilities on US policy-making, which include having regard to the effects of policy on others.

10. The European countries might want to press still harder the point about the US having responsibilities to others. But I do not believe that, when it comes to the point, Chancellor Schmidt would be able to bring himself to deny the correctness of the anti-inflationary stance; and I have not heard that any of the Europeans have more positive proposals to make about US methods of achieving their ends than the ones I have outlined. So I think that if you were to speak on broadly these lines you might find that you had made a contribution to a more harmonious Summit.

11. I am very conscious of the need not to part company from the Germans over this, if we can help it, since we need their support over other important Community matters in the coming months. But we do support President Reagan's approach. And, however frank the discussion in the course of the Ottawa Summit, it would be very serious if it could not be brought, at the end, to some kind of an agreed conclusion.

12. We shall be offering you a speaking note for the European Council.

13. I am sending copies of this minute to the Foreign Secretary and to Sir Robert Armstrong.

h.m. (G.H.)

18 June 1981