SECRET Prime Minister [2]

25 April 1983
ALAN WALTERS

PRIME MINISTER

MLS 25/4

YOUR WASHINGTON AND WILLIAMSBURG CONVERSATIONS WITH THE PRESIDENT OF THE UNITED STATES (27 MAY-1 JUNE)

Martin Feldstein tells me that, in a number of meetings with the President on economic policy, the President is nostalgic for the "good old days" when there was financial stability. (This explains his brief flirtation a year or so ago with a possible return to the gold standard, now thankfully dropped.) But there is a danger that the President may be induced to agree in general terms to some programme involving some degree of fixity in exchange rates. This he might do in an unthinking way and, when the implications were pointed out to him, he would withdraw his support and return to proclaiming the need for free markets in currencies.

The President would agree that exchange rate intervention cannot repel market forces. He abhors the loss, by intervention, of tax-payers' money. The recent case of French intervention, to the tune of $28 billion, with losses of at least $2 billion, is an object lesson.

The United States will welcome the Jurgenson Report as being "useful" - they will interpret the results as showing that there is only a very limited role for intervention in the very short term. So the United States will continue to restrict intervention to "day-to-day-smoothing". Like us, the United States will not entertain any system of international sanctions against any state that does or does not intervene according to some surveillance criteria or to some EMS-type rule.

Above all, the United States and the President believe, with us, that the way to stability is through appropriate monetary and fiscal policies, and not through exchange rate gimmicks. This gives us a basis for our proposal on an MTFS for the Summit countries.

The big shadow is, of course, cast by the Federal deficit. Feldstein believes that the President needs to be reassured that tax increases which would reduce expected deficits would help significantly in reducing long term dollar interest rates. Feldstein has considerable admiration for our 1981 Budget and the way in which we simultaneously increased taxes, brought the interest rates down and promoted recovery.

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According to Feldstein, the President has enormous admiration and respect for you; he would take your advice on this matter very seriously. Indeed Feldstein argued that only you could do it!

The CEA and Treasury plans are to have lagged increases in taxes which will come into operation, after the Election, in October or perhaps early in 1985. They hope this will have an effect on interest rates at a much earlier date. The intention is to get the Federal deficit to about 2% of GDP in the latter part of the 1980s. (In my opinion that is still too high to have zero inflation.)

It is widely reported in the press that George Shultz is in favour of more control over exchange rates. This is incorrect. Shultz has made statements about "how nice it would be if we had more stability", but he certainly did not envisage any EMS-type or Bretton Woods regime. He would, if pressed, say that such stability can be achieved only by stability in monetary-fiscal policies.

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