RECORD OF DISCUSSION BETWEEN THE CHANCELLOR AND SECRETARY REGAN AT 6.15 P.M. ON 28 MAY 1983 IN WILLIAMSBURG

Duplicate.

PRESENT:

Chancellor of the Exchequer	Secretary Regan
Mr Littler	Mr Sprinkel
Mr Kerr	Mr Leland

1. The Chancellor and Secretary Regan briefly reviewed the handling of discussions among Finance Ministers in the forthcoming Summit. They agreed in particular on the undesirability of any endorsement of the Mitterrand suggestion for a new Bretton Woods. Secretary Regan said that President Mitterrand had, at a bilateral meeting with President Reagan earlier on 28 May, distanced himself from the press coverage of his remarks on 9 May. In particular, he had acknowledged that the original Bretton Woods Conference had taken 4 years to prepare; and had denied that he had ever publicly or privately advocated a return to fixed exchange rates.

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2. The Chancellor referred to the IMF issues likely to come before the executive board in June/July; and the interim committee in September. He saw some advantage in envisaging an additional G.5 ministerial meeting in late July to review progress. The SDR issue was one on which some co-ordination of views at ministerial level at that stage might be particularly useful. Secretary Regan agreed: a meeting in the last 10 days of July would be timely, particularly given the plan for a meeting of G.5 deputies on 8 July. Secretary Regan assumed that, since the meeting would not be in the 'surveillance' series, Larosiere would not be asked to attend. The Chancellor agreed.

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Brazil

3. The Chancellor said that he had been disturbed by evidence that the Brazilians were not complying in full with the IMF adjustment programme. It might be valuable if the Americans, who carried the most clout with them, could press them to keep up to the mark. Secretary Regan warmly agreed, saying that Secretary Shultz had in fact written on 27 May to the Brazilians in strong terms pointing out that assistance of all kinds to Brazil would start to evaporate if the fund programme were seen to be set on one side. The US authorities would press the Brazilians "as hard as it takes": the next step, if more was required, would be a message from the President.

IMF Quotas

4. The Chancellor congratulated Secretary Regan on the progress through Congress of the Bill approving the increase in IMF quotas agreed on 8 February. Secretary Regan, while acknowledging that the Bill was making fairly rapid progress, expressed concern at some of the amendments which had been added to it. Mr Leland implied that some amendments - those affecting the commercial banks - were so unattractive as to raise the question of a possible veto. Secretary Regan demurred: the worst amendments had, he thought, been struck off. But there still were grounds for concern, particularly as the Administration objected to anything which encouraged commercial banks to reduce their lending abroad. He referred to a leak to the Wall Street Journal of an internal Lloyds Bank International paper on lending to developing countries: this implied that LBI would in future be taking a much more restrictive line. The Chancellor said that he had not seen the text.

Bilateral Issues

5. The Chancellor referred to the US/UK consultations on 23/24 May on the anti-trust actions against British airlines. His understanding was that these had gone well, and that a sensible programme of work had been agreed. This would of course require the US Justice Department to extend their subpoenas on the airlines. He emphasised that if the process of negotiation now in train were to break down, the resulting

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situation would be very serious, and not just for British Caledonian. At issue was the fundamental principle that inter-governmental agreements, in this case air services agreements, should not be called in question by legal proceedings in national courts. Secretary Regan,claiming to be unsighted, instructed Mr Leland to look into the question. It was not one in which the US Treasury had hitherto been involved; but it sounded as if their involvement would be required.

6. The Chancellor then referred to the Export Administration Act, stressing the very difficult issues raised for HMG by the extra-territoriality issue. Secretary Regan claimed that the Bill as amended in the House would give the President powers to intervene only in respect of sales to the Soviet Union of equipment produced in the United States by US firms. The original version of the Bill would have extended also to foreign firms selling to the Soviet Union US-designed products produced abroad. He had initially resisted this. He was content with the version now before the House, but was very concerned by a rival version now in the Senate. It would give the President powers to block imports into the US of products produced anywhere, whether or not the sales to the Soviet Union by the firm in question, which were deemed to affect US security, were of US-designed equipment. His hope was that the compromise version which eventually emerged would be closer to that in the House than that in the Senate.

US Deficit

7. The Chancellor expressed renewed concern about the prospect of rising US deficits in future years, and the impact in the markets, visible in very high real interest rates. Secretary Regan said that the alleged causal relationship between high deficits and high interest rates was a grey area: he remained unconvinced. If the Chancellor would like to send a British economic expert to work through the arguments with his people, that would be very welcome. Clearly there

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was some relationship between levels of government borrowing and levels of real interest rates, but he did not believe that it was as straightforward as foreign commentators currently suggested. Mr Littler argued that Federal deficits absorbing 85% and more of US domestic savings must be bound to put upward pressure on interest rates: Mr Sprinkel however maintained that, with rapid growth now envisaged, resources for private sector investment would be generated from profits, rather than borrowing. Mr Sprinkel added that the Administration's growth forecasts earlier in the year had been far too modest. With an improved growth performance, the deficit problem would diminish. Each extra percentage point of GNP growth would take $100 billion off the deficit. *

8. The Chancellor drew attention to the importance of market perceptions. What mattered, for interest rates, was whether the markets expected the deficit to remain high. Clearly they did. We in the UK had faced a rather similar situation in 1980/81, and had resolved it in the 1981 Budget, when, at the depth of the recession, we had imposed sharp real increases in indirect taxatation, and had not increased income tax allowances/thresholds at all. The Chancellor showed Secretary Reagan a chart illustrating the impact of the 1981 Budget on the UK PSBR as a proportion of GNP, and comparing US and UK performance. Secretary Regan said that if the US deficit remained above 3% of GNP in 1985, increases in direct taxation would take effect. His guess was that the proportion in 1985 would in fact be between 3 and 4%. The Chancellor wondered whether it might not make sense to envisage some increases in indirect taxation before then. Our experience in 1981 had demonstrated the value of convincing the markets of one's determination to put one's borrowing on a declining path. Secretary Regan referred to difficulties in Congress.

9. The Chancellor said that concern about the prospective levels of the US deficit would underlie much of the Summit discussion. What worried him and his European and Japanese colleagues was the prospect that world-wide real interest rates would remain high, given the dominant

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influence of US financial markets. Secretary Regan said that the latest evidence suggested that monetary policy would be likely to have more effect on interest rates than fiscal policy. In the last three weeks interest rates in New York had started to edge up in response to money supply increases. Reining in money supply growth might change the picture again. The Chancellor thought that both fiscal and monetary policy were important; and that the climb out from world recession would be bound to decelerate if interest rates remained high. But he welcomed Secretary Regan's offer of discussions on these issues among experts; and suggested that he might ask Mr Burns to visit the Treasury at Washington. Secretary Regan said that Mr Burns would be very welcome.

10. The meeting ended at 7 p.m.

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Distribution:

PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Middleton
Mr Burns
Mr Littler
Mr Unwin
Mr Carey
Mr Lavelle
Mr Odling-Smee
Mr Ridley
Mr Kemp
Mr Bottrill

Mr Coles (No 10)
Mr Fall (FCO)
Mr Rhodes (DOT)
Sir O Wright (HMA Washington)
Mr Evans (FCO)
Mr Wicks (UKDEL IMF/IBRD W'ton)
Mr Hatfield (Cabinet Office)

* (para 7)
Mr Sprinkel subsequented 'clarified' his calculation; explaining to Mr Littler that 1% per year extra growth for 5 years might reduce the deficit by $100B in the fifth year.

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